

In the Matter of )  
 )  
Petition for Forbearance From )  
the Current Pricing Rules for )  
the Unbundled Network Element )  
Platform )

July 1, 2003

## **SUMMARY**

The Commission should forbear from its decision permitting UNE-P carriers to collect per-minute access charges from long distance carriers when it is the incumbent that actually provides the exchange access service, and, in addition, should forbear from applying its current TELRIC pricing rules to the so-called UNE platform.

The Commission has indicated that it intends to initiate a proceeding to reform its current TELRIC pricing rules. The Commission should do so expeditiously and move to a pricing standard based on the incumbent's actual forward-looking costs rather than the hypothetical network construct that underlies TELRIC. While the Commission completes this reform of its rules, it should immediately take the interim steps set forth in this petition to ameliorate the most harmful effects of those rules.

The Commission's current pricing rules for the UNE-Platform suffer from multiple flaws. First, the TELRIC rules themselves are inherently flawed. Because TELRIC assumes a hypothetical, ideally efficient network, it produces UNE rates that are lower than any real-world carrier can match. As a result, it fails to compensate incumbents fairly for the use of their networks and discourages investment by all carriers (incumbents and newer entrants alike). Second, the problems inherent in TELRIC are exacerbated by applying it to the so-called UNE platform. Applying TELRIC to the UNE platform creates a system of uneconomic arbitrage in which carriers obtain margins of 50 percent or more by merely reselling services over existing facilities without making any investments, while incumbents continue to bear the costs of maintaining and operating the network. In fact, UNE-platform carriers now openly tout the fact that under current rules they are able to reap large margins without the need for any infrastructure investment. And the arbitrage opportunity is so great it has even spawned a

cottage industry dedicated to helping carriers exploit the windfall arbitrage opportunities. Third, the problems are further compounded by the fiction embodied in current rules that UNE-P carriers are providing exchange access service and can collect the per-minute access charges from long distance carriers. In fact, it is the incumbent, as the underlying facilities provider, that is providing the exchange access service. The Commission's rule creates a loophole that lets UNE-P carriers skim off access charge revenues that were intended to support the ongoing operation and maintenance of the network infrastructure – not add to the profits of arbitrageurs investing little or nothing in the local network.

As actual market experience abundantly shows, the effect of the current pricing rules (along with the overly broad unbundling requirements) is three-fold. First, they have devalued the existing investments by incumbents and newer entrants alike in the nation's telecommunications infrastructure and are therefore profoundly deflationary. Indeed, the market capitalization of the telecommunications and equipment manufacturing sectors has declined by approximately \$2 *trillion* since 2000. The rules effectively act as a tax on investment, allowing carriers with no facilities of their own to drain billions of dollars of revenue from the competing facilities-based providers (both incumbents and newer entrants) that deploy and maintain the nation's telecommunications infrastructure.

Second, the rules have contributed materially to the massive decline in investment in the telecommunications industry – a decline of roughly \$60 billion in the wireline segment of the industry from 2000 to 2002 alone. Indeed, the TELRIC prices are so extreme that they even have caused competing carriers to curtail the use of their *existing* facilities in favor of UNE-P. Because of the importance of the telecommunications sector to the overall economy, this decline in investment has undermined growth of the national economy.

Third, the rules have precluded the development of a rational wholesale market because no carrier will negotiate to reach a market-based agreement when it can instead take advantage of below-cost TELRIC rates.

The Commission has ample discretion to take interim measures to immediately address some of the most harmful aspects of its pricing rules even while it completes its general reform of those rules. For example, as a small interim step toward remedying the larger arbitrage problem, the Commission could simply eliminate the fiction that a UNE-P carrier is providing the exchange access on long distance calls. This would recognize that the underlying facilities provider, as the entity that is actually providing those services, is entitled to the per-minute exchange access charges since the very purpose of those revenues is to support the operation and maintenance of the network infrastructure. Likewise, the Commission would be well within its authority to forbear from applying TELRIC to UNE-P and determine that, when a CLEC purchases a platform of all the elements necessary to provide service, the level of compensation to which the ILEC is entitled is no lower than it would receive under the Act's resale pricing standard.

Given all of this, the standard for forbearance set out in section 10 of the Act is unquestionably met. Forbearance will help to ameliorate the harmful effects of the current pricing rules, compensate incumbents more fairly, promote investment and the continued growth of facilities-based competition, and, in so doing, boost the overall economy. Thus, forbearance will advance consumer interests and is in the public interest.

Accordingly, the Commission should immediately move to grant this petition.

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**I. THE CURRENT PRICING RULES THAT APPLY TO UNE-P ARE FLAWED IN MULTIPLE RESPECTS.**

<sup>1/</sup> The Verizon telephone companies (“Verizon”) are the affiliated local telephone companies of Verizon Communications Inc. These companies are listed in Attachment A.

As an initial matter, TELRIC itself is flawed. The core problem with TELRIC is that, rather than being grounded in the incumbent's existing network, it is based on regulators' conceptions of the hypothetically most efficient technologies and network configuration (with the sole exception of wire center locations). This hypothetical network construct creates two basic problems.

First, it results in UNE rates that are well below what the ILEC, or any other real-world carrier, could match. As a result, TELRIC discourages investment by all carriers. A competing carrier is less likely to incur the risks and costs of investing in its own facilities when it can obtain UNEs at rates based on the most efficient theoretical network imaginable and when any investment can be undercut by CLECs who benefit from below-cost UNE rates. And TELRIC discourages new investment by ILECs by requiring them to provide their network facilities to competitors at rates that will not permit ILECs to recover their investment.

Second, by basing rates on a hypothetical network, TELRIC functions as a "black box": it lacks any objective criteria or standards on which to base rates and accordingly provides considerable latitude to set rates without regard to costs. As a result, TELRIC has been applied, both in successive rounds of price setting proceedings and through this Commission's section 271 benchmarking standard, to ratchet down rates that previously were set in compliance with the TELRIC rules to lower levels based on ever more extreme assumptions. Since the beginning of 2002, for example, UNE-P rates have decreased by more than 30 percent in Arizona, Indiana, and California; by more than 20 percent in Idaho, Wisconsin, Utah, and Kentucky; and between

17 and 20 percent in Iowa, Georgia, Washington, Illinois, North Dakota, and Nebraska.<sup>2/</sup> This rapid reduction in UNE-P rates is not the result of some corresponding reduction in the *costs* of providing UNEs. Instead, this steady downward trend has been driven by pressure to produce the appearance of competition by providing CLECs what they claim is a “sufficient” profit margin between UNE prices and retail rates, which themselves are often artificially low, to make it worth their while to “compete” in a given state.

Independent analysts repeatedly have concluded that the result of all this is to produce artificially low rates that are well below any realistic measure of the incumbent’s costs. For example, the May 1, 2002 quarterly report from Commerce Capital Markets provided a comprehensive analysis of UNE rates that have been established under the TELRIC pricing regime. The report concluded that “[f]or all RBOCs, UNEs are priced below cash operating cost, and radically below total operating cost including depreciation and amortization. The discounts from total cost are 50%-60% below total cost even when total cost does not include cost of equity, a component that is allowed under TELRIC.”<sup>3/</sup> Based on that analysis, the report concluded that “. . . regulators are forcing RBOCs to wholesale their network at rates that are significantly below the costs that the financial community looks at.” *Id.*

The application of TELRIC to the UNE-P construct exacerbates its flaws. The artificially low UNE-P rates resulting from TELRIC allow carriers using UNE-P to resell services over existing facilities, not at the resale pricing standard prescribed by Congress, but at discounts of

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<sup>2/</sup> See The Negative Effect of Applying TELRIC Pricing to the UNE Platform on Facilities-Based Competition and Investment, at 1-13 (Attachment B hereto) (“*Report on Negative Effect of the UNE Platform*”).

<sup>3/</sup> A. Kovacs, et al. Commerce Capital Markets, Inc., *The Status of 271 and UNE-Platform in the Regional Bells’ Territories* at 15 (May 1, 2002) (emphasis added).



50% or more without having any facilities of their own or adding anything unique of value. Moreover, the incumbent must still bear the full costs of operating and maintaining the network. The result, as a JP Morgan study concluded, is that “[w]hile the Bells lose roughly 60% of the revenues when they lose a line to a UNE-P based competitor, we estimate that they retain 95% of the costs.”<sup>4/</sup> As a result, “UNE-P functions like a tax on investment, rather than a competitive incentive.”<sup>5/</sup>

In addition, under the current rules, UNE-P carriers are able to earn substantial margins by selectively focusing on attractive urban and business customers. For example, a December 2002 Legg Mason study found that CLECs relying on UNE-P had average gross margins at the time ranging from 47% to 66% in Massachusetts, Pennsylvania, Maine, Maryland, Delaware, Rhode Island, Vermont, Virginia, New Jersey, the District of Columbia, and New York.<sup>6/</sup>

The fiction embodied in the current rules that the UNE-P carrier provides exchange access service on the line only further compounds the problem. In reality, it is the ILEC as the underlying facilities provider that is actually providing the exchange access service and bearing the costs of doing so. And, of course, exchange access charges were designed to help pay for the cost of the underlying network infrastructure. Thus, the Commission’s rule diverts access charge revenues that were designed to support the network infrastructure and simply adds to the uneconomic arbitrage opportunity available to UNE-P carriers. Indeed, one consultant emphasizes that a key “benefit with the UNE-P/CLEC arrangement” is the ability to collect

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<sup>4/</sup> M. Crossman, *et. al*, J.P. Morgan Securities, Inc., *Industry Update – No Growth Expected for Bells in 2003* at 15 (July 12, 2002).

<sup>5/</sup> See Scott Cleland, Precursor Group, “*Why UNE-P Is Going Away: Telecom’s Changing Trajectory*” (Oct. 2, 2002).

<sup>6/</sup> Legg Mason, *UNE-P Relief: Investors Expect Too Much* at 9 (Dec. 19, 2002).

access charges from long distance carriers and touts the fact that “UNE-P/CLEC’S can pay their ILEC bills [just with the access charges they receive] and keep all of the revenue they collect from their End Users.”<sup>7/</sup> The consultant’s website goes so far as to provide a “calculator” to let carriers estimate how much they can collect through this access charge loophole.

## **II. THE CURRENT PRICING RULES FOR UNE-P ARE PROFOUNDLY UNECONOMIC, IMPEDE COMPETITION, AND HARM BOTH THE TELECOMMUNICATIONS INDUSTRY AND THE ECONOMY AS A WHOLE.**

Actual market experience in the time since the current pricing rules were adopted demonstrates that those rules have produced UNE-P prices that fail to compensate the incumbents fairly for the use of their networks and that deter, rather than promote, investment in competing telephone networks and services. The effect of those rules has been three-fold.

*First*, the application of TELRIC rules to UNE-P has created a system of uneconomic arbitrage that has devalued existing investments by incumbents and newer entrants alike in the nation’s telecommunications infrastructure and is inherently deflationary. As one analyst put it, “the macroeconomic consequences of the FCC’s TELRIC fiat was to devalue three quarters of the Nation’s telecom infrastructure by two-thirds.”<sup>8/</sup> Indeed, the market capitalization of the telecommunications and equipment manufacturing sectors has declined by some \$2 *trillion* since 2000 alone.<sup>9/</sup>

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<sup>7/</sup> See ISG Telecom, “Revenues for the UNE-P CLEC,” *available at* <http://www.isg-telecom.com/> (visited June 22, 2003).

<sup>8/</sup> *Hearings before the Subcomm. On Telecommunications Trade & Consumer Protection of the House Commerce Comm.*, 106th Cong. 2 (May 25, 2000) (Written statement of Scott Cleland, Managing Director, The Precursor Group) (“Cleland Statement”).

<sup>9/</sup> See, e.g., S. Rosenbush, *et al.*, “Inside the Telecom Game: How a Small Group of Insiders Made Billions as the Industry Collapsed,” *Business Week* 34 (Aug. 5, 2002) (“Investors have lost some \$2 trillion [in telecom] as stock prices have tumbled 95% or more from their highs.”); P. Starr, “The Great Telecom Implosion,” *The American Prospect* 2024 (Sept. 9, 2002)

The rules have created this result by allowing carriers with no facilities of their own to drain literally billions of dollars of revenues away from the competing providers that deploy and maintain that infrastructure. The TELRIC rules devalue the investments of incumbent carriers by prescribing rates for those facilities that substantially understate any real-world measure of their costs. And they devalue investments by competing facilities-based providers because CLECs that take advantage of the arbitrage opportunity created by TELRIC, particularly when applied to UNE-P, can undercut those investments. Thus, as one analyst has concisely explained, the “consequences of the FCC’s strategy has been to effectively devalue all infrastructure investment by everyone, incumbents and competitors alike.” *See* Cleland Statement at 2.

*Second*, the application of TELRIC to UNE-P has unquestionably contributed to a massive decline in telecommunications industry investment, directly contravening the core goal of the 1996 Act. Because of the importance of the telecommunications sector to the overall economy, it also has hampered economic growth.

As independent analysts at McKinsey & Co. and JP Morgan have explained, the incentives created by TELRIC are clear: “[n]o company will deploy and scale facilities if it can achieve similar economics immediately by renting network elements from the ILECs – all with little up-front investment.”<sup>10/</sup> Similarly, as Scott Cleland of the Legg Mason Precursor Group put it, “why overbuild if one can lease it more cheaply than one can build it? We strongly

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(“Out of the \$7 trillion decline in the stock market since its peak, about \$2 trillion have disappeared in the capitalization of telecom companies.”).

<sup>10/</sup> McKinsey & Co. and JP Morgan H&Q, *Broadband 2001, A Comprehensive Analysis of Demand, Supply, Economics, and Industry Dynamics in the U.S. Broadband Market* at 18 (Apr. 2, 2001).

suspect that the success of the UNE-P resale will adversely affect the incentive for facilities-based competition.”<sup>11/</sup> Other analysts have likewise concluded that “[s]ix years following the Act, we are left with virtually no structural incentive for any company to ever build an alternative local network that will compete with local carriers over time”<sup>12/</sup> and that “under a more rational local competitive framework, overbuilding might have occurred to a greater extent.”<sup>13/</sup>

The numbers bear this out. According to one recent report, between 2000 and 2002, as previously prescribed TELRIC rates were further slashed, overall investment by wireline telecommunications carriers declined from \$104.8 billion to \$42.8 billion – a decline of more than \$60 billion in just two years.<sup>14/</sup> This downward trend applies to incumbents and competing carriers alike. For example, one analyst estimates that total capital expenditures by the Bell companies combined declined by approximately 35 percent from 2001 to 2002 alone.<sup>15/</sup> Meanwhile, capital expenditures by facilities-based CLECs reportedly declined by 19 percent from 2000 to 2001, and by 56 percent from 2001 to 2002.<sup>16/</sup> And the *Wall Street Journal*

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<sup>11/</sup> Cleland Statement at 2; *see also* S. Cleland, Precursor Group, *Why UNE-P Is Going Away: Telecom Competition's Changing Trajectory* (Oct. 2, 2002).

<sup>12/</sup> Gregory P. Miller, *et al.*, Fulcrum Global Partners, *Wireline Communications: Thoughts on FCC Order* at 2 (Feb. 25, 2003).

<sup>13/</sup> B. Roberts, *et al.*, Dresdner Kleinwort Wasserstein, *UNE-P: The Unprofitable RBOC* at 3 (Aug. 9, 2002).

<sup>14/</sup> Skyline Marketing Group, *CapEx Report: 2002 Annual Report*, Carrier Data Sheet 1 (June 2003).

<sup>15/</sup> UBS Warburg, *Are the Bells Growing Less Profitable?* at 41 (April 16, 2003).

<sup>16/</sup> Association for Local Telecommunications Services, *The State of Local Competition 2003* at 10 (Apr. 2003).

recently reported that “spending on equipment by the six major telecom operators that have reported was down an average of 19% in the first quarter [of 2003] compared with the same period the year before, widely considered to be the worst year in the telecom industry’s history.”<sup>17/</sup>

In fact, many ostensible competitors state that under the current rules they have no intention of *ever* deploying their own facilities. One CLEC, for example, has told investors that its “UNE-P-based business model allows us to avoid significant capital investments in network facilities.”<sup>18/</sup> Similarly, other CLECs have assured the markets that they “can now lease the necessary elements of the Bell network – without the need for costly network infrastructure, which allows us to earn attractive gross margins” and that they are “deploying very little capital” to provide UNE-P service.<sup>19/</sup>

The arbitrage opportunity is so great it even has spawned the creation of a cottage industry dedicated to helping companies “become a UNE-P CLEC” in order to take advantage of the “50% to 70% Net Profit Available” in an environment where “[n]o equipment investment is required!”<sup>20/</sup> One consultant informs potential UNE-P carriers that “no switching equipment is

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<sup>17/</sup> A. Latour, *et al.*, *A Wrong Number for Telecom: Big Operators Cut Spending 19%*, Wall St. J. (Apr. 28, 2003).

<sup>18/</sup> See Z-Tel, 2001 Annual Report at ii (“Z-Tel was formed around UNE-P.”).

<sup>19/</sup> Talk America, 2001 Annual Report at 7; Wayne Huyard, Chief Operating Officer, MCI, *Using UNE-P To Develop a Strong and Profitable Local Presence*, Goldman-Sachs Telecom Issues Conference, New York, NY (May 7, 2002); *see also* Talk America, Form 10-K/A at 6 (SEC filed Apr. 12, 2002) (Talk America “believes that UNE-P currently provides it with a cost-effective means of adding local service to its existing long distance product offerings.”).

<sup>20/</sup> See American Discount Telecom, “50% to 70% Net Profit Available to Competitive Telephone Companies,” available at <http://a-adt.com> (visited June 5, 2003); *see also* “The U S Supreme Court Wants CLEC’s To Make More Money With UNE-P! You Don’t Need Resale Anymore!,” available at <http://a-adt.com/une-p-clec.html> (visited June 5, 2003).

required, but instead you lease ports on the ILEC's switches for a fraction of the cost of purchasing equipment," which produces "profit margins" that "range from 50-90%."<sup>21/</sup>

In addition to declining investment in new facilities, the current TELRIC rules also have caused CLECs to curtail the use of their *existing* facilities in favor of the UNE platform at artificially low TELRIC rates. For example, in just eight states where carriers now make extensive use of UNE-P, competing carriers connected more than 600,000 *fewer lines* to their own switches using unbundled loops in 2002 than they did in 2000.<sup>22/</sup> During the same period of time, competing carriers nationwide added more than 9 million UNE-P lines – an increase of approximately 2000 percent. *Id.* at 16. Independent analysts have observed the same trend.<sup>23/</sup>

Moreover, competing carriers not only are adding substantially fewer *new* lines to their existing facilities, but have begun to move *existing* customers that they were serving using their own facilities to UNE platform arrangements. For example, evidence filed with the Commission in its *Triennial Review* proceeding demonstrated that a number of carriers had begun to transfer lines off their own switches and onto UNE-P arrangements.<sup>24/</sup> This trend is consistent with the

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<sup>21/</sup> ISG Telecom, *Revenues for the UNE-P CLEC*, available at <http://www.isg-telecom.com>.

<sup>22/</sup> *Report on Negative Effect of UNE-P* at 15-16. The eight states are New York, New Jersey, Massachusetts, Georgia, Florida, Illinois, California and Texas.

<sup>23/</sup> See, e.g., R.E. Talbot, RBC Capital Markets, Investext Rpt. No. 7229059, *Integrated Telecommunication Services – Moderating Expectations for Triennial Review – Industry Report* at \*13 (Feb. 18, 2003) ("Competitor UNE Lines with CLEC switching declined to 35% (or 4.1 million) of total UNE switched lines. This compares to 39% (3.7 million) in the preceding six months and 67% as at December 1999. We expect this trend to continue as CLECs pursue UNE-P based strategies in additional markets.").

<sup>24/</sup> See, e.g., UNE Rebuttal Report 2002 at 31, n.161, *Review of the Section 251 Unbundling Obligation of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, *et al.* (FCC filed Oct. 23, 2002); Letter from William Barr, Verizon, to Michael Powell, FCC, at 17-18, *attached to Ex Parte Letter from Ann Berkowitz, Verizon, to Marlene Dortch, FCC*, CC Docket No. 01-338 (Oct. 16, 2002).

Commission's own data, which shows that the number of CLEC-owned lines other than those provided through cable *decreased* by 700,000 lines between December 2000 and December 2002, while the number of UNE-P lines increased from 2.8 to 10.2 million. *Report on Negative Effect of the UNE Platform* at 20.

CLECs also have expanded the use of UNE-P to classes of customers that previously were served predominantly using some or all of the CLECs' own facilities. This trend is evident in the business market, which has previously been a particularly attractive market for competing carriers to deploy their own facilities. For example, the percentage of competing carriers' business lines served by UNE-P in Verizon's region more than doubled (from 6 percent to 13 percent) from the end of 2001 to February 2003. *Report on Negative Effect of the UNE Platform* at 17. Other examples abound.

The reason for this trend is succinctly stated: TELRIC not only deters carriers from investing in the first place, it also harms those competing carriers that have chosen to pursue a facilities-based strategy because such carriers find themselves competing against below-cost UNEs. Facilities-based carrier Allegiance Telecom, for example, has indicated that low UNE-P prices "mak[e] it more difficult for efficient facilities-based [competitive local exchange carriers] to compete."<sup>25/</sup> Independent analysts too have recognized that TELRIC's artificially low prices harm facilities-based carriers. Credit Suisse First Boston noted that it "turned pessimistic about the extent to which Cox Communications will generate money from offering local telephone service over its cable TV systems" because "the long distance carriers' use of UNE-P has picked

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<sup>25/</sup> See Letter from Kevin M. Joseph, Vice President Government Affairs, Allegiance Telecom, Inc., to the Magalie Salas, FCC, CC Docket No. 96-98, Attachment at 2 (Feb. 2, 2001).

up speed of late.”<sup>26/</sup> Similarly, Legg Mason, commenting on WorldCom’s plan to expand its UNE-P offerings, wrote: “the more successful the plan is, the more it will reduce the attractiveness of the telephony opportunity for cable.”<sup>27/</sup>

*Third*, the TELRIC rules have precluded the development of a rational wholesale market. Incumbents have every incentive to recover their costs by filling their networks with revenue-producing traffic. While an incumbent would generally prefer to have the end user as its customer and collect the resulting retail revenues, it clearly would rather collect the revenue generated by having the wholesale traffic on its network than forfeit this revenue entirely because that traffic ended up on alternative facilities, such as cable and wireless networks. This is particularly true because incumbents already are losing millions of lines and billions of minutes to facilities-based competitors, including cable telephony providers, wireless carriers, and less traditional sources of competition such as voice over IP, e-mail, and instant messaging. *See generally Report on Negative Effect of the UNE Platform* at 20-29. Thus, incumbents have strong reasons to enter into rational, voluntary wholesale arrangements at compensatory rates.

Incumbents find themselves in a similar position to AT&T when the long distance market was opened to competition. In that case, as here, AT&T had market incentives to offer competitive but rational terms to wholesale customers to keep as much long distance traffic as possible on its network rather than having traffic migrate to competing facilities. As a result, a wholesale market developed in which carriers purchased capacity from AT&T at compensatory

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<sup>26/</sup> George Mannes, *Cox’s Prospects for Growth May Be Fading*, The Street.com (Sept. 19, 2002), available at <http://www.thestreet.com/tech/georgemannes/10043045.html> (citing Credit Suisse First Boston analyst Lara Warner).

<sup>27/</sup> B. Levin, *et al.*, Legg Mason Wood Walker, *WorldCom/MCI Bundled Phone Offer Challenges Rivals, Regulators* at 2 (Apr. 23, 2002).



rates and resold that capacity to end users. TELRIC, particularly when applied to UNE-P, has precluded the development of a similarly rational wholesale market for local telecommunications by setting rates that are well below the costs of any real-world carrier.

### **III. THE COMMISSION HAS AMPLE AUTHORITY TO TAKE INTERIM STEPS TO LIMIT THE HARMFUL EFFECTS OF APPLYING THE CURRENT PRICING RULES TO UNE-P.**

The Commission has ample authority to adopt interim measures to ameliorate the most harmful aspects of the current pricing rules while it completes its proceeding to reform those rules more generally.

As an initial matter, the relevant provisions of the Act do not, as the Commission has recognized, require the current TELRIC pricing rules. Rather, section 252(d)(1) specifies only that UNE prices are to be based on “the cost . . . of providing . . . the network element,” plus a “reasonable profit.” The generality of those terms led the Supreme Court to conclude that the statute “leaves [pricing] methodology largely subject to the Commission’s discretion.”<sup>28/</sup>

Likewise, the Commission has recognized that nothing in the Act or elsewhere requires that prices be based on “a particular variant of forward-looking economic cost, such as TELRIC.”<sup>29/</sup>

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<sup>28/</sup> See *Verizon Communications v. FCC*, 535 U.S. 467, 499-500 (2002) (“[T]he Act uses ‘cost’ as an intermediate term in the calculation of ‘just and reasonable rates,’” and “regulatory bodies required to set rates expressed in these terms have ample discretion to choose methodology.”) (internal citations omitted); *id.* at 500 (“[W]ords like ‘cost’ ‘give rate setting commissions broad methodological leeway; they say little about the ‘method employed’ to determine a particular rate.’”).

<sup>29/</sup> See, e.g., Memorandum Opinion and Order, *AT&T Corporation v. Bell Atlantic Corporation, et al.*, 15 FCC Rcd 17066, 17069 ¶ 9 n.16 (2000) (“In citing past examples of approaches to forward-looking cost, we did not somehow confine the term ‘forward-looking economic cost’ to those examples, nor did we convert the requirement in the text of the *Merger Order* – that Bell Atlantic employ forward-looking costs as a general matter – into a more rigorous requirement that Bell Atlantic employ a particular variant of forward-looking economic cost, such as TELRIC.”).

As discussed above, it is now clear that applying TELRIC to UNE-P arrangements does not come close to permitting incumbents to cover any real-world measure of their costs of providing UNEs, forward-looking or otherwise, let alone earn a reasonable profit.

Similarly, nothing in the Act says a word about the UNE-P. Rather, the UNE-P is a regulatory construct devised by the Commission. As Chairman Powell has explained, UNE-P “wasn’t in the statute. It was sort of a creative combination of the Commission.”<sup>30/</sup> The Act obligates an incumbent only to lease to competitors individual pieces of its network that satisfy the necessary and impair standards of section 251(d)(2) or to provide wholesale services for resale by competitors at a discount based on the incumbent’s “avoided costs.” The Commission determined, however, that incumbents also must provide access on an “unbundled” basis to a fully bundled “platform” of facilities necessary to provide precisely the service that the incumbent already provides. This is beyond the requirements of sections 251 and 252 themselves. Although the Supreme Court upheld the Commission’s discretion to embrace this “all elements” fiction under the Act, *Iowa Utils. Bd. v. FCC*, 525 U.S. 366, 392-93 (1999), it said nothing to foreclose a different result based on actual market experience in the time since then.

In any event, to the extent that the Commission had discretion to create the UNE-P, it also has discretion to define the pricing rules that apply. In particular, the Commission would be well within its interpretive authority to hold that, when a CLEC wishes to purchase a platform of all the network elements necessary to provide an existing service, the compensation to the

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<sup>30/</sup> “Powell Defends Stance on Telecom Competition,” *Communications Daily* (May 22, 2001); *see also Competition Issues in the Telecommunications Industry*, Hearings before the Senate Comm. on Commerce, Science, and Transportation, 108th Cong. (2003) (Written statement of Michael K. Powell, Chairman, FCC) (“UNE-P is not a network element, nor does the statute provide for it as a complete entry vehicle. UNE-P is a consequence of previous regulatory decisions . . .”).

incumbent should be no lower than under the resale pricing standard prescribed by Congress (or at alternative rates a CLEC negotiates with the ILEC). *See* 47 U.S.C. §§ 251(c)(4), 252(d)(3). Such an approach would have immediate and beneficial effects by ending the most pernicious form of uneconomic arbitrage and the disincentives it creates for investment by incumbents and entrants alike. At the same time, as Congress itself determined by including the resale provision within the Act, it would provide a means for CLECs to enter the market and establish a customer base while they deploy at least some of their own facilities.

Likewise, the Commission has ample authority simply to eliminate the fiction that a UNE-P carrier provides exchange access services to originate and terminate long distance traffic on a UNE-P line, and forbear from its current rule that UNE-P carriers are entitled to collect per-minute access charges from IXC's for the provision of exchange access service.<sup>31/</sup> In reality, a CLEC that purchases UNE-P simply acts as a marketer of local services provided using the incumbent's facilities. It is the incumbent that continues to provide exchange access for the origination, termination, and transport of long distance calls. Indeed, in the case of exchange access service, a UNE-P carrier does not even engage in the retail marketing functions that it does in connection with local service. And because exchange access charges were designed as a way to help pay for the underlying network infrastructure, determining that the incumbent, as the underlying facilities provider, is entitled to the per-minute access charges would ensure that the

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<sup>31/</sup> First Report and Order, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 15499 ¶¶ 358-65 (1996) ("Local Competition Order").

underlying network provider receives the payments that were intended to support the ongoing operation and maintenance of that network.<sup>32/</sup>

Moreover, such an approach also is consistent with the expressed intent of Congress that the 1996 Act should not disrupt the pre-existing access charge regime that helped pay for the local network. Section 251(g) of the Act expressly provides that LECs “shall provide exchange access . . . in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (*including receipt of compensation*) that apply to such carrier” prior to the Act. 47 U.S.C. § 251(g) (emphasis added). As the Commission has stated in describing the effect of section 251(g), “[b]efore Congress enacted the 1996 Act, LECs provided access services to IXC’s and to information service providers in order to connect calls that travel to points - both interstate and intrastate - beyond the local exchange. In turn, both the Commission and the states had in place access regimes applicable to this traffic, which they have continued to modify over time. It makes sense that Congress did not intend to disrupt these pre-existing relationships.”<sup>33/</sup> Thus, the Commission may properly condition the continued availability of UNE-P at TELRIC rates on the payment by long distance carriers of per-minute access charges to the incumbent.

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<sup>32/</sup> See, e.g., First Report and Order, *In the Matter of Access Charge Reform*, 12 FCC Rcd 15982 ¶¶ 17, 21 (1997) (noting that “[t]he access charge rules provide for the recovery of the incumbent LECs’ costs assigned to the interstate jurisdiction” for “the costs of th[e] common plant” that is “needed to originate and terminate interstate long-distance calls”).

<sup>33/</sup> Order on Remand and Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996: Intercarrier Compensation for ISP-Bound Traffic*, 16 FCC Rcd 9151, 9168 ¶ 37 (2001). Although the D.C. Circuit subsequently criticized the Commission’s reliance on section 251(g) in this order, it did so on the ground that “there had been *no* pre-Act obligation relating to intercarrier compensation for ISP-bound traffic.” *WorldCom, Inc. v. FCC*, 288 F.3d 429, 433 (D.C. Cir. 2002). That reasoning obviously is inapplicable to access charges for exchange access service, for which there clearly were rules and obligations in place prior to the Act.

Although the Commission previously concluded that incumbents should not receive exchange access charges when they provide network elements, it is free to forbear from that conclusion as it applies to the UNE-P for several reasons. First, the Commission previously reached this conclusion based primarily on the theory that TELRIC rates “represent[] full compensation to the incumbent LEC for use of the network elements that carriers purchase” and that permitting recovery of access charges accordingly would “constitute double recovery.”<sup>34/</sup> As described above, marketplace experience since the Commission’s decision has demonstrated that UNE-P rates clearly do not provide incumbents recovery of any real-world measure of their costs. In any event, there would be no double recovery even if TELRIC were not flawed. The incumbent would collect only one usage-based charge for each call: it would receive only per-minute access charges from long distance carriers for long distance calls, and it would receive only per-minute UNE charges (e.g., switching and shared transport charges) from CLECs for local calls.

Second, the Commission has not explicitly considered whether its access charge conclusion should apply in the case of the UNE platform, an issue that raises unique interpretive questions concerning the applicability of the resale and UNE pricing standards to a regulatory construct that is as a practical matter largely identical to a resale arrangement. Because the UNE platform is nothing more than a regulatory fiction that allows a CLEC to pay TELRIC rates rather than the wholesale rates prescribed by statute for what amounts to a resale arrangement, the Commission may reasonably conclude that the fiction should not extend so far as to deprive the incumbent of the access charges it would receive under a standard resale arrangement.

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<sup>34/</sup> First Report and Order, *In the Matter of Access Charge Reform*, 12 FCC Rcd 15982 ¶ 337 (1997); *see also Local Competition Order* ¶ 363.

Third, because neither the UNE platform nor the TELRIC methodology is sacrosanct, to the extent that UNE-P continues to be available at TELRIC rates while the Commission completes its proceeding to reform its pricing rules generally, it is well within the scope of the Commission's power to condition that discretionary availability on the incumbent's receiving payment of per-minute access charges for any interstate traffic originated or terminated on the line at issue.<sup>35/</sup> The Commission, of course, routinely conditions the availability or approval of a particular benefit on the fulfillment of particular conditions.<sup>36/</sup>

Fourth, as the Commission itself concluded in the *Local Competition Order*, nothing in the statute precludes it from determining, at least on an interim basis until it reforms its TELRIC rules, that in order to promote an important statutory goal, the incumbent should collect per-minute access charges for the origination or termination of interstate traffic.<sup>37/</sup> Though the

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<sup>35/</sup> See, e.g., *United States v. Chesapeake & Ohio R.R.*, 426 U.S. 500, 514-15 (1976) (upholding as "a legitimate, reasonable, and direct adjunct to the Commission's explicit statutory [suspension] power" the ICC's authority agency to withhold suspension of a tariff that would increase railroad rates subject to the condition that the railroad use the resulting proceeds for capital improvements and deferred maintenance); *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631, 655-56 (1978) (upholding ICC order suspending oil pipeline's initial rate tariff but permitting pipeline to file revised tariff, at specified interim rates, to take effect on one-day's notice, subject to the condition that the pipeline agree to refund the difference between any amounts collected during and after the suspension period and the amounts ultimately held to be reasonable).

<sup>36/</sup> See, e.g., Seventh Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform*, 16 FCC Rcd 9923 ¶¶ 3-4 (2001) (conditioning the ability of CLECs to continue temporarily to charge above-market rates for terminating access in exchange for a mechanism under which those rates would be required to benchmark to ILEC rates over time); Order on Remand and Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic*, 16 FCC Rcd 9151 ¶ 89 (2001) (conditioning the ability of ILECs to take advantage of the new intercarrier compensation regime on their willingness to offer "to exchange all traffic subject to section 251(b)(5) at the same rate").

<sup>37/</sup> See *Local Competition Order* ¶¶ 726-27. The Commission's decision on this score was upheld by the Eighth Circuit in *Competitive Telecommunications Ass'n v. FCC*, 117 F.3d 1068

reasons justifying forbearance here differ somewhat from those on which the Commission relied for its decision in the *Local Competition Order*, the need here is no less compelling. Indeed, in that case, the Commission was concerned that entry and investment decisions “would be driven by regulatory distortions . . . rather than the unfettered operation of a competitive market.” *Local Competition Order* ¶ 719. Likewise, the application of below-cost TELRIC rates to UNE-P, combined with CLECs’ ability to collect per-minute access charges from IXC’s, has led to massive regulatory arbitrage that is distorting carriers’ investment and entry decisions.

In sum, the Commission has ample discretion to forbear from applying TELRIC to UNE-P or, alternatively, to permit UNE-P carriers, rather than incumbents, to collect per-minute access charge revenue.

#### **IV. THE STANDARDS FOR FORBEARANCE ARE UNQUESTIONABLY SATISFIED.**

Section 10 of the Act provides that the Commission “shall” forbear from applying any regulation or any provision of the Act to telecommunications carriers if the Commission determines that the three conditions set forth in Section 10 are satisfied. All of Section 10’s conditions are met here. Indeed, given the flaws inherent in the current pricing rules for UNE-P

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(8th Cir. 1997). Of course, the only issue in that case was whether the Commission’s decision to require payment of certain access charges to incumbents on an interim basis was reasonable, and the court’s only holding was that the decision was reasonable. To the extent dicta in that decision might be read to suggest that the Act required those charges to be phased out under the circumstances at issue there, that obviously does not tie the Commission’s hands here. On the contrary, neither the Commission’s nor the court’s decision reflected any consideration of the unique circumstances presented by a CLEC’s use of the UNE platform at TELRIC prices, nor did it take account of the Commission’s power to condition the availability of the UNE platform at those prices on the payment of such access charges. Moreover, here the Commission would not be requiring CLECs to *pay* access charges in addition to UNE rates as it did in the *Local Competition Order*; rather, it would simply be forbearing from its decision allowing them to collect that revenue from long distance carriers in the first place based on a recognition that a UNE-P carrier does not provide exchange access service.

and the negative effect they have on the development of facilities-based competition, the public interest requires that the Commission move expeditiously to remedy the most harmful aspects of those pricing rules.<sup>38/</sup>

**A. The Current Pricing Rules for UNE-P Are Not Necessary To Ensure That Charges, Practices, Classifications, or Regulations Are Just and Reasonable and Are Not Unjustly or Unreasonably Discriminatory.**

With respect to the first prong of the section 10 analysis, and as the foregoing discussion amply demonstrates, the current pricing rules for UNE-P are not necessary to ensure just, reasonable, and nondiscriminatory rates. This is true for several reasons.

First, as discussed above, the current pricing rules produce rates that are well below any rational measure of the costs of providing the UNE-P and accordingly – far from being “necessary” to ensure just and reasonable rates – actually result in unjust and unreasonable rates. Such rates are unjust because they do not compensate ILECs for even the actual forward-looking costs that incumbents incur on behalf of the CLECs that purchase the UNE-P. And they are unreasonable because they discourage investment by all carriers and thereby undermine one of the core goals of the 1996 Act.

Second, the current pricing rules for UNE-P are not necessary to ensure just and reasonable rates because there are better alternatives. Ultimately, of course, the Commission can and should revise its pricing rules so that UNE rates are set based on the incumbent’s actual forward-looking costs. But even prior to completing that general reform, as described above, the

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<sup>38/</sup> Because, as discussed above, neither TELRIC nor UNE-P is required by the Act, Section 10(d) of the Act in no way limits the Commission’s ability to forbear from applying its current pricing rules for UNE-P. That section only precludes the Commission from forbearing “from applying the *requirements* of section 251(c) or 271 . . . until it determines that those requirements have been fully implemented.” 47 U.S.C. § 160(d) (emphasis added). In addition, once a carrier receives long distance authority in a given state, the Commission itself has concluded that those requirements have been fully implemented. *See* 47 U.S.C. § 271(d)(3)(A)(i).



Commission can forbear from applying the portion of the current regime that entitles UNE-P carriers to collect per-minute access charges from long distance carriers. Similarly, the Commission can forbear from applying TELRIC to UNE-P and say that incumbents should receive compensation for UNE-P that is no less than provided under the resale standard, thereby restoring the balance that Congress originally struck.

Finally, the current pricing rules for UNE-P are unnecessary to ensure nondiscriminatory rates. First, they are not necessary to protect against discrimination among CLECs because, to the extent that the Commission determined that the resale pricing standard should govern in place of TELRIC in the case of UNE-P, the same rates would apply to all CLECs. Likewise, forbearance from the Commission's decision allowing CLECs to collect access charges would not differentiate among CLECs. Nor is there any plausible argument that the current pricing rules are somehow necessary to protect against discrimination between CLECs and incumbents themselves. To the contrary, those rules discriminate against *incumbents* by providing CLECs access to network facilities at rates below the costs that the incumbent itself must bear when it uses those facilities. Accordingly, forbearance is required to eliminate this disparity and put incumbents and CLECs on the same footing.

**B. The Current Pricing Rules Are Not Necessary for the Protection of Consumers.**

Similarly, with respect to the second prong of section 10, applying the current pricing rules to UNE-P is not necessary to protect consumers. On the contrary, forbearance will affirmatively further consumer interests by encouraging the development of facilities-based competition and by promoting the kind of innovation and meaningful consumer choice that only real, as opposed to merely "synthetic," competition can produce. Thus, applying the current

pricing rules lacks “a strong connection” to, and is not “required to achieve[,] the desired goal of consumer protection.” *CTIA v. FCC*, No. 02-1264, slip op. at 17 (D.C. Cir. June 6, 2003).

As demonstrated above, the current pricing rules have dampened investment and innovation by incumbents and competitors alike and encouraged CLECs to rely on UNE-P even in cases where they could provide service more efficiently using at least some of their own facilities. The result has been fewer genuine choices for consumers than would otherwise exist. While carriers using UNE-P can “compete” with incumbents in terms of marketing and other retailing functions, because they rely on the same underlying network facilities as the incumbent, their ability to innovate and offer new services or functionalities is limited. As Justice Breyer observed, “[i]t is in the *unshared*, not in the *shared*, portions of the enterprise that meaningful competition would likely emerge.”<sup>39/</sup> Thus, forbearing will remove the disincentives for efficient investment and affirmatively promote consumer interests by triggering the virtuous cycle of investment and innovation that only real facilities-based competition can produce.

There also is no basis for any claims that applying the current pricing rules to UNE-P is necessary to prevent consumers from being harmed. On the contrary, while forbearance may mean that CLECs have smaller profit margins than they currently do for services that they provide using UNE-P at artificially low TELRIC rates, they will be in no different position than incumbents. Like the incumbents and other competitors, CLECs using UNE-P will have to make business decisions about how best to recover their costs over their full range of services and customers. While some individual customers or services may not be profitable because of uneconomic retail price regulations, that same problem confronts the incumbents. It merely

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<sup>39/</sup> *Iowa Utils. Bd.* 525 U.S. at 429 (Breyer, J., concurring in part and dissenting in part).

means that, like incumbents, CLECs will have to serve a range of customers and provide a variety of services in order to recoup their costs.

Indeed, one of the clear trends that has emerged as a result of competition from alternative delivery platforms is for service providers to offer a wide array of bundled service options that provide consumers numerous services at a single attractive price. This trend began with new pricing plans introduced by wireless providers that included flat rated bundles of minutes (including any distance minutes), packaged together with additional services such as voice mail and caller ID. Likewise, today cable companies offer their own package deals. For example, Cox Communications offers the Cox Value Bundle, where a customer can “save up to \$238” by subscribing to “all three services – Standard Cable, High Speed Internet, and Digital Telephone.”<sup>40/</sup> Similarly, facilities-based competing carriers also offer bundled services. For example, RCN reports that its RCN Essentials package allows the customer to “build [their] own bundle [by combining] Cable TV, unlimited local Phone Service, and High-Speed Internet.”<sup>41/</sup> In the face of competition from these competing facilities platforms, incumbents have rolled out innovative packages of their own. For example, Verizon’s “Variations All” plan allows customers to “save as much as a third off the regular price of individual services” with annual savings of “\$250 a year for the long distance, wireless and DSL components” and “\$800 per year when local services are included.”<sup>42/</sup>

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<sup>40/</sup> Cox Communications, *Hampton Roads, VA, Bundle Savings*, available at <http://www.cox.com/hamptonroads/bundle.asp>.

<sup>41/</sup> RCN, *Essentials*, available at <http://www.rcn.com/essentials/index.php>.

<sup>42/</sup> Verizon Press Release, *Verizon Revolutionizes Communications Service for Consumers With one Package, One Call, One Bill for Local, Long-Distance, DSL and Wireless* at 2 (Aug. 6, 2002).

Consequently, consumers already have begun to see the benefits of real competition from multiple facilities-based platforms. By restoring incentives for further investment in alternative facilities and technologies, forbearance from applying the current pricing rules to UNE-P will only accelerate this trend.

**C. Forbearance Is Consistent with the Public Interest.**

Finally, with respect to the third prong of the analysis, forbearance is in the public interest.

As explained in detail above, the current pricing rules have contributed materially to a massive decline in telecommunications investment.<sup>43/</sup> Forbearance will restore rational investment incentives and help to turn this disturbing tide, while also promoting “competition among providers of telecommunications services.” 47 U.S.C. § 160(b). The benefits of added investment will flow not just to the telecommunications sector itself, but also to the ailing equipment manufacturers and high-tech sectors. Indeed, because of the importance of the telecommunications industry to the overall economy, forbearance can contribute to economic growth and the country’s international economic competitiveness.

In addition, by encouraging carriers to deploy redundant network facilities that could become critical in the event of a terrorist attack or some other calamity that might befall the incumbent carriers’ networks, forbearance also will contribute to national security. As Chairman Powell has noted, “[o]nly through facilities-based competition can our Nation attain greater

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<sup>43/</sup> Robert E. Litan, *The Telecommunications Crash: What To Do Now?*, Brookings Policy Brief #112 (Dec. 2002); S. Rosenbush, et al., *When Will the Telecom Depression End?*, Business Week (Oct. 7, 2002).

network redundancies for security purposes and national emergencies.”<sup>44/</sup> Commissioner Martin also has acknowledged the importance of redundant network facilities to national security stating “as we saw on September 11, there are network reliability and security advantages to having multiple facilities-based competitors.”<sup>45/</sup> In light of all these considerations, forbearance unquestionably will promote the public interest.

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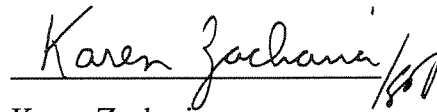
<sup>44/</sup> Michael K. Powell, Chairman, FCC, Remarks Before the Goldman Sachs Communicopia XI Conference, New York, N.Y. at 6 (Oct. 2, 2002).

<sup>45/</sup> Kevin J. Martin, Commissioner, Federal Communications Commission, *Framework For Broadband Deployment*, Remarks Before the National Summit On Broadband Deployment (Oct. 26, 2001).

## CONCLUSION

For the foregoing reasons, the Commission should forbear from applying its current pricing rules to the UNE-P.

Respectfully submitted,

A handwritten signature in cursive script, reading "Karen Zacharia", followed by a diagonal line and a small mark.

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July 1, 2003

## THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

Contel of the South, Inc. d/b/a Verizon Mid-States  
GTE Midwest Incorporated d/b/a Verizon Midwest  
GTE Southwest Incorporated d/b/a Verizon Southwest  
The Micronesian Telecommunications Corporation  
Verizon California Inc.  
Verizon Delaware Inc.  
Verizon Florida Inc.  
Verizon Hawaii Inc.  
Verizon Maryland Inc.  
Verizon New England Inc.  
Verizon New Jersey Inc.  
Verizon New York Inc.  
Verizon North Inc.  
Verizon Northwest Inc.  
Verizon Pennsylvania Inc.  
Verizon South Inc.  
Verizon Virginia Inc.  
Verizon Washington, DC Inc.  
Verizon West Coast Inc.  
Verizon West Virginia Inc.

## **THE NEGATIVE EFFECT OF APPLYING TELRIC PRICING TO THE UNE PLATFORM ON FACILITIES-BASED COMPETITION AND INVESTMENT**

This report demonstrates how TELRIC pricing has led to a rise in the use of the UNE platform and a concomitant decrease in facilities-based competition and investment in the telecommunications industry. *First*, it describes how the TELRIC rates for the elements that make up the UNE-P have been reduced to increasingly lower levels in recent years. *Second*, it demonstrates that as use of the UNE-P at TELRIC rates has increased, there has been a decrease in facilities-based competition and in investment by competing carriers and incumbents alike. *Finally*, it shows that facilities-based competition is increasingly coming from intermodal sources such as wireless, cable, and voice over IP networks; that, in contrast, UNE-P carriers now openly tout the fact that the availability of UNE-P at TELRIC rates allows them to earn large margins without even investing in facilities; and that the availability of UNE-P at TELRIC rates has spawned a new cottage industry dedicated to exploiting the opportunity for uneconomic arbitrage.

### **A. The Ratcheting Down of TELRIC Rates for the UNE Platform.**

In recent years, the rates for the unbundled network elements that make up the UNE platform have been reduced to increasingly lower levels. As described in more detail below, in just the last year, rates that were previously set based on the Commission's TELRIC rules were reduced yet again, in many cases by an average of as much as 20 to 40 percent in a given state – and in the case of some individual rates by as much as 80 percent or more. *See* Table 1.<sup>1</sup> As a result of such decreases, a December 2002 Legg Mason study found that CLECs relying on the UNE-P at TELRIC rates had average gross margins at the time ranging from 47 percent to 66 percent in virtually every Verizon state – Massachusetts, Pennsylvania, Maine, Maryland, Delaware, Rhode Island, Vermont, Virginia, New Jersey, the District of Columbia, and New York.<sup>2</sup> And the downward trend in prices has continued since that time. This trend is a result of a flaw in the rules themselves, which base prices on the costs of a hypothetical network rather than on the costs of the incumbents' real-world telephone networks.

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<sup>1</sup> *See also* A. Quinton, *et al.*, Merrill Lynch, *The Telecommunicator: Telecom Act Seven Years On* (In-Depth Report) at 19 (Sept. 23, 2002) (“*Merrill Lynch Telecommunicator Comment*”) (Since the beginning of 2002, UNE-P rates have been slashed by more than 40 percent in New Jersey; more than 30 percent in California; more than 20 percent in Colorado, Idaho, Iowa, and Maine; and between 16 and 18 percent in Kentucky, Montana, North Dakota, Washington and Rhode Island).

<sup>2</sup> Legg Mason, *UNE-P Relief: Investors Expect Too Much* at 9 (Dec. 19, 2002).



<b>Table 1. Overview of Recent Rate Reductions in Verizon's Region</b>		
<b>State</b>	<b>2-wire Analog Loop</b>	<b>Local Switching</b>
New York	-21%	-64%
New Jersey	-41%	-78%
Pennsylvania	-18%	-84%
Massachusetts	-7%	-79%
Florida	-15%	-44%
Maine	-8%	-75%
Washington, D.C.	-60%	-88%
New Hampshire	-13%	-25%
Maryland	-17%	-56%
West Virginia	-17%	-71%
Delaware	n/a	-31%
Rhode Island	n/a	-86%
Virginia	n/a	-36%
California	-31%	-60%

1. In Verizon's region, there are five states – New York, New Jersey, Pennsylvania, Massachusetts, and Florida – in which the state commission has completed a second-generation pricing proceeding. In each case, the new pricing proceeding was completed within a few years of an earlier pricing proceeding in which the state commission had found that the initial rates it established were TELRIC-compliant. And in each case, the state commission established new rates that are significantly lower than the previous rates that were found TELRIC-compliant.

*New York.* The New York PSC initially established UNE rates in April 1997 that it found were TELRIC-compliant.<sup>3</sup> The PSC established a statewide average loop rate of \$14.52 and an average switching rate of \$0.003150 per minute.<sup>4</sup> These rates were upheld by a federal district court in New York.<sup>5</sup> They were subsequently found TELRIC-compliant by the FCC in the course of Verizon's section 271 application.<sup>6</sup> And the D.C. Circuit expressly affirmed that

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<sup>3</sup> See *Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corporation, WorldCom, Inc., d/b/a LDDS WorldCom, and the Empire Association of Long Distance Telephone Companies, Inc. Against New York Telephone Company Concerning Wholesale Provisioning of Local Exchange Service by New York Telephone Company and Sections of New York Telephone Company's Tariff No. 900*, Opinion and Order Setting Rates for First Group of Network Elements, 95-C-0657, 94-C-0095 & 91-C-1174, Opinion No. 97-2 (NY PSC Apr. 1, 1997); *id.* at 15 ("The case was litigated on a TELRIC basis; all parties contemplate its being decided on that basis; [and] TELRIC is certainly a reasonable approach to use."); *id.* at 13 ("Notwithstanding the court's staying of the FCC's pricing rules, the parties continued to rely on the TELRIC standard.").

<sup>4</sup> The rate is a weighted average of daytime, evening, and night rates of \$0.003806, \$0.001837, and \$0.001508, respectively.

<sup>5</sup> See *MCI Telecomms. Corp. v. New York Tel. Co.*, 134 F. Supp. 2d 490 (N.D.N.Y. 2001).

<sup>6</sup> See *Application by Bell Atlantic New York for Authorization under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York*, Memorandum Opinion and Order, 15 FCC Rcd 3953, ¶¶ 242-244 (1999).

finding.<sup>7</sup> The PSC nonetheless initiated a new pricing proceeding in January 1999.<sup>8</sup> In May 2001, the administrative law judge overseeing the proceeding issued a recommended decision to establish new, significantly lower rates.<sup>9</sup> In January 2002, the PSC issued a UNE Order establishing final permanent rates.<sup>10</sup> The PSC reduced the statewide average loop rate to \$11.49 and reduced the switching rates to \$0.001147 per originating minute and \$0.001111 per terminating minute.

New York UNE Rates			
	April 1997	January 2002	% reduction
2-wire analog loop (statewide average)	\$14.52	\$11.49	-21%
Local switching	\$0.003150 (average rate/min.)	\$0.001147 (originating rate/min.)	-64%

*New Jersey.* The New Jersey BPU initially established UNE rates in December 1997 that it found were TELRIC-compliant.<sup>11</sup> The BPU established a statewide average loop rate of \$16.21 and a switching rate of \$0.005418 per originating minute and \$0.003207 per terminating minute. In June 2000, the BPU opened a new pricing proceeding. In November 2001, the BPU adopted new, significantly lower UNE rates.<sup>12</sup> The BPU adopted a statewide average loop rate of \$9.52 and a switching rate of \$0.002773 per originating minute and \$0.002508 per terminating

<sup>7</sup> See *AT&T Corp. v. FCC*, 220 F.3d 607, 617 (D.C. Cir. 2000).

<sup>8</sup> See *Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corporation, WorldCom, Inc., d/b/a LDDS WorldCom, and the Empire Association of Long Distance Telephone Companies, Inc. Against New York Telephone Company Concerning Wholesale Provisioning of Local Exchange Service by New York Telephone Company and Sections of New York Telephone Company's Tariff No. 900*, Order Denying Motion to Reopen Phase 1 and Instituting New Proceeding at 12, 95-C-0657, 94-C-0095, 91-C-1174 & Case 98-C-1357 (NY PSC Sept. 30, 1998).

<sup>9</sup> See *Proceeding on Motion of the Commission To Examine New York Telephone Company's Rates for Unbundled Network Elements*, Recommended Decision on Module 3 Issues by Administrative Law Judge Joel A. Linsider, Case 98-C-1357 (NY PSC May 16, 2001).

<sup>10</sup> See *Proceeding on Motion of the Commission To Examine New York Telephone Company's Rates for Unbundled Network Elements*, Order on Unbundled Network Element Rates, Case 98-C-1357 (NY PSC Jan. 28, 2002).

<sup>11</sup> See *Investigation Regarding Local Exchange Competition for Telecommunications Services*, Order Regarding Interconnection and Resale, Docket No. TX95120631 (NJ BPU Dec. 2, 1997); *id.* at 9 (“[T]he parties to this phase of this proceeding agree the proper basis for setting rates for interconnection and unbundled elements contemplates the use of a long-run incremental cost methodology . . . [Therefore] the Board *HEREBY ADOPTS* the principles upon which the FCC’s TELRIC model is based.”). AT&T and WorldCom appealed the rates set by the New Jersey BPU. See *AT&T Communications v. New Jersey, Inc. v. Bell Atlantic-New Jersey, Inc.*, Nos. 97-5762 & 98-0109, slip. op. (D.N.J. June 6, 2000). The court remanded the BPU’s decision on the ground that it had not provided sufficient explanation for the cost model it adopted, but did not reach the question whether the actual rates set by the BPU complied with TELRIC. See *id.* at 27-28, 31.

<sup>12</sup> See *Review of Unbundled Network Element Rates, Terms and Conditions of Bell Atlantic New Jersey, Inc.*, Board Meeting Transcript, Docket No. TO00060356 (NJ BPU Nov. 20, 2001); *Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic New Jersey*, Summary Order of Approval, Docket No. TO00060356 (NJ BPU Dec. 17, 2001).

minute. The FCC found these rates TELRIC-compliant in June 2002.<sup>13</sup> In April 2002, AT&T and WorldCom filed a petition for reconsideration of the BPU's order. In September 2002, the BPU issued an order on reconsideration that further lowered the switching rates, to \$0.001203 per originating minute and \$0.001171 per terminating minute.<sup>14</sup>

New Jersey UNE Rates			
	December 1997	September 2002	% reduction
2-wire analog loop (statewide average)	\$16.21	\$9.52*	-41%
Local switching (originating per-minute rate)	\$0.005418	\$0.001203	-78%
*The loop rate in New Jersey was originally reduced in December 2001.			

*Pennsylvania.* The Pennsylvania PUC initially established UNE rates in August 1997 that it found were TELRIC-compliant.<sup>15</sup> The PUC established a statewide average loop rate of \$16.78 and a switching rate of \$0.011067 per originating minute and \$0.006143 per terminating minute. In September 1999, following additional proceedings, the PUC established new, substantially lower UNE rates.<sup>16</sup> The PUC established a statewide average loop rate of \$14.50 (which was set to decrease, and did decrease, to \$13.81 effective May 2001<sup>17</sup>) and a switching rate of \$0.001802 per originating minute and \$0.001615 per terminating minute. The FCC found these rates TELRIC-compliant in September 2001.<sup>18</sup> The Pennsylvania PUC is now nearing completion of a third-generation pricing proceeding.

<sup>13</sup> See *Application by Verizon New Jersey Inc., et al., for Authorization To Provide In-Region, InterLATA Services in New Jersey*, Memorandum Opinion and Order, 17 FCC Rcd 12275, ¶ 18 (2002).

<sup>14</sup> *Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic - New Jersey, Inc.*, Order on Reconsideration, Docket No. TO00060356 (NJ BPU Sept. 13, 2002).

<sup>15</sup> See *Application of MFS Intelenet of Pennsylvania, et al.*, Final Opinion and Order, Docket Nos. A-310203F0002, *et al.* (PA PUC Aug. 7, 1997); *Application of MFS Intelenet of Pennsylvania, et al.*, Interim Order, Docket Nos. A-310203F0002, *et al.* at 13 (PA PUC Apr. 10, 1997) (“inasmuch as we have consistently used or required the use of the FCC’s TELRIC methodology throughout the several phases of this proceeding, we will continue to use TSLRIC as a tool to evaluate the proposals before us and view the *FCC Order* as instructive in the proper application of a long-run incremental cost methodology.”). A federal district court remanded the PUC’s decision to clarify whether it followed the FCC’s TELRIC rules. The district court did not review the substance of the order, but decided the case solely on the fact that the PUC called its methodology “TSLRIC” rather than “TELRIC.” *MCI Telecomms. Corp. v. Bell Atlantic-Pennsylvania, Inc.*, No. 97-CV-1857 (M.D. Pa. 2000). The Third Circuit reversed and remanded the district court’s decision. See *MCI Telecomms. Corp. v. Bell Atlantic-Pennsylvania, Inc.*, 271 F.3d 491, 522 (3d Cir. 2001).

<sup>16</sup> See *Joint Petition of NextLink Pennsylvania, Inc., et al.*, Opinion and Order, Docket Nos. P-00991648, *et al.* (Pa. PUC Sept. 30, 1999), *aff’d*, 763 A.2d 440 (Pa. Commw. Ct. 2000).

<sup>17</sup> See *Verizon Pennsylvania Inc., Services for Other Telephone Companies*, PA PUC Tariff No. 216 § 3.C.1(a).

<sup>18</sup> See *Application of Verizon Pennsylvania Inc., et al. for Authorization To Provide In-Region, InterLATA Services in Pennsylvania*, Memorandum Opinion and Order, 16 FCC Rcd 17419, ¶ 55 (2001).

Pennsylvania UNE Rates			
	August 1997	September 1999	% reduction
2-wire analog loop (statewide average)	\$16.78	\$13.81*	-18%
Local switching (originating per-minute rate)	\$0.011067	\$0.001802	-84%
*The \$13.81 loop rate in Pennsylvania became effective May 2001.			

*Massachusetts.* The Massachusetts DTE set initial rates for UNEs in 1997.<sup>19</sup> The DTE set a statewide average loop rate of \$14.98 and an average switching rate of \$0.003637 per minute.<sup>20</sup> In March 1999, the DTE found that the rates it established were TELRIC-compliant.<sup>21</sup> In November 2000, while Verizon's section 271 application for Massachusetts was pending before the FCC, Verizon had to reduce the switching rates in Massachusetts to \$0.00472 per originating and terminating minute in order to satisfy the FCC's benchmark test.<sup>22</sup> The FCC found those rates TELRIC-compliant in April 2001.<sup>23</sup> The D.C. Circuit subsequently upheld that determination.<sup>24</sup> In June 2002, Verizon was required during an FCC complaint proceeding to reduce the switching rates in Massachusetts further in order to satisfy a new benchmark based on newly adopted rates in New York.<sup>25</sup> In June 2003, the DTE completed a second-generation proceeding in which it adopted new rates.<sup>26</sup> Pursuant to that decision, the new statewide average

<sup>19</sup> See *Consolidated Petitions of New England Telephone Company d/b/a NYNEX, Teleport Communications Group, Inc., Brooks Fiber Communications, AT&T Communications of New England, Inc., MCI Communications Company, and Sprint Communications Company, L.P., Pursuant to Section 252(b) of the Telecommunications Act of 1996, for Arbitration of Interconnection Agreements Between NYNEX and the Aforementioned Companies*, Order, DPU 96-73/74, 96-75, 96-80/81, 96-83, 96-94 (Phase 4-D) (MA DPU June 27, 1997).

<sup>20</sup> The rate is a weighted average of peak-metro, peak-other, and off-peak rates of \$0.004647, \$0.004724, and \$0.001872, respectively.

<sup>21</sup> See *Investigation by the Department on Its Own Motion into the Propriety of the Resale Tariff of New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts, Filed with the Department on January 16, 1998, To Become Effective February 14, 1998*, Order at 16, DTE 98-15 (Phases II, III) (MA DTE Mar. 19, 1999) ("[T]he Department finds that it correctly applied the FCC's avoided cost and TELRIC methods in *Consolidated Arbitrations*.").

<sup>22</sup> See Reply Declaration of Steven E. Collins ¶¶ 4-5, *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), and Verizon Global Networks Inc., for Authorization To Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 00-176 (FCC filed Nov. 3, 2000).

<sup>23</sup> See *Application of Verizon New England Inc., et al., For Authorization to Provide In-Region, InterLATA Services in Massachusetts*, Memorandum Opinion and Order, 16 FCC Rcd 8988 ¶ 20 (2001).

<sup>24</sup> See *WorldCom, Inc. v. FCC*, 308 F.3d 1 (D.C. Cir. 2002).

<sup>25</sup> See *WorldCom, Inc., Complainant, v. Verizon New England, Inc., Bell Atlantic Communications, Inc. (dba Verizon Long Distance), NYNEX Long Distance Company (dba Verizon Enterprises Solutions), and Verizon Global Networks, Inc., Defendants*, Memorandum Opinion and Order, 17 FCC Rcd 15115, ¶ 13 (2002).

<sup>26</sup> See *Investigation by the Department of Telecommunications and Energy on Its Own Motion into the Appropriate Pricing, Based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts*, Order, DTE

loop rate in Massachusetts is \$13.99 and the new switching rate is \$0.000825 per originating minute and \$0.000724 per terminating minute.

Massachusetts UNE Rates			
	November 2000	June 2003	% reduction
2-wire analog loop (statewide average)	\$14.98*	\$13.99	-7%
Local switching	\$0.003637 (average rate/min.)	\$0.000825 (originating rate/min.)	-79%
*The loop rate was set earlier, in March 1999			

*Florida.* The Florida PSC initially established wholesale UNE rates for Verizon in January 1997 in an arbitration proceeding involving AT&T.<sup>27</sup> The PSC established a statewide average loop rate of \$20.00 and a switching rate of \$0.004000 per originating minute and \$0.003750 per terminating minute. In May 1999, the PSC initiated a proceeding to establish new rates. In November 2002, the PSC issued an order adopting new rates.<sup>28</sup> It reduced the statewide average loop rate to \$17.07 and reduced the switching rate to \$0.002257 per originating and terminating minute.<sup>29</sup>

Florida UNE Rates			
	January 1997	November 2002	% reduction
2-wire analog loop (statewide average)	\$20.00	\$17.07	-15%
Local switching (originating per-minute rate)	\$0.004000	\$0.002257	-44%

2. There are two additional states in Verizon's region – Maine and the District of Columbia – that completed their initial pricing proceedings late relative to other states. These states have adopted rates that are significantly below the rates that were effective in the interim while these proceedings were pending.

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01-20 (MA DTE July 11, 2002); *Investigation by the Department of Telecommunications and Energy on Its Own Motion into the Appropriate Pricing, Based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts*, Order Granting Verizon and AT&T Motions for Reconsideration, in Part, and Requesting Additional Evidence, DTE 01-20 (MA DTE Sept. 24, 2002).

<sup>27</sup> See *Petitions by AT&T Communications of the Southern States, Inc., MCI Telecommunications Corporation and MCI Metro Access Transmission Services, Inc., for Arbitration of Certain Terms and Conditions of a Proposed Agreement with GTE Florida Incorporated Concerning Interconnection and Resale under the Telecommunications Act of 1996*, Final Order on Arbitration, Docket Nos. 960847-TP, 960980-TP, Order No. PSC-97-0064-FOF-TP (FL PSC Jan. 17, 1997).

<sup>28</sup> See *Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track)*, Final Order on Rates for Unbundled Network Elements Provided by Verizon Florida, Docket No. 990649B-TP, Order No. PSC-02-1574-FOF-TP (FL PSC Nov. 15, 2002).

<sup>29</sup> Those rates have been stayed pending Verizon's appeal to the Florida Supreme Court.

*Maine.* Between 1996 and February 2002, Verizon offered UNEs to CLECs in Maine at rates that had resulted from an arbitration between Verizon and AT&T.<sup>30</sup> The statewide average loop rate during that period was \$17.53 and the average switching rate was \$0.006712 per minute.<sup>31</sup> The Maine PUC adopted permanent UNE rates for the first time in February 2002.<sup>32</sup> It adopted a statewide average loop rate of \$16.18, which is currently in effect. In March 2002, the Maine PUC required additional modifications to the switching rates established in the February 2002 order, lowering them considerably from those in effect before February 2002.<sup>33</sup> The switching rate in Maine is now \$0.001680 per originating and terminating minute.

Maine UNE Rates			
	December 1996	March 2002	% reduction
2-wire analog loop (statewide average)	\$17.53	\$16.18	-8%
Local switching	\$0.006712 (average rate/min.)	\$0.001680 (originating rate/min.)	-75%

*Washington, D.C.* Between 1996 and December 2002, Verizon charged rates for UNEs based on the proxy rates developed by the FCC in 1996.<sup>34</sup> These rates included a statewide average loop rate of \$10.81 and a switching rate of \$0.003 per originating and terminating minute. The PSC established permanent UNE rates for the first time in December 2002.<sup>35</sup> It lowered the statewide average loop rate to \$4.29 and the switching rate to \$0.00038 per originating minute and \$0.00034 per terminating minute. Following the PSC's decision, Verizon petitioned the PSC to reconsider its decision, which triggered a stay of the PSC's new rates pursuant to District of Columbia law. In the interim while that stay is pending, Verizon was required to reduce the rates to meet the FCC's benchmark test.<sup>36</sup> The benchmarked rates in

<sup>30</sup> See Joint Declaration of Edward B. Dinan, Patrick A. Garzillo and Michael Anglin ¶ 19, *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services, Inc. for Authorization to Provide In-Region, InterLATA Services in Maine*, CC Docket No. 02-61 (FCC filed March 21, 2002); *AT&T of New England, Inc., New England Telephone and Telegraph Company d/b/a NYNEX Requests for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996*, Commission Decisions on Arbitrated Issues, Docket No. 96-510 (ME PUC Dec. 4, 1996).

<sup>31</sup> The rate is a weighted average of daytime, evening, and night rates of \$0.007186, \$0.008092, and \$0.003840, respectively.

<sup>32</sup> See *Investigation of Total Element Long-Run Incremental Cost (TELRIC) Studies and Pricing of Unbundled Network Elements*, Order at 1, Docket No. 97-505 (ME PUC Feb. 12, 2002).

<sup>33</sup> See *Investigation of Total Element Long-Run Incremental Cost (TELRIC) Studies and Pricing of Unbundled Network Elements*, Order, Docket No. 97-505 (ME PUC Mar. 8, 2002).

<sup>34</sup> See *Consolidated Issues Raised in Petitions for Arbitration Pending Before the Public Service Commission*, Order No. 5, Telecommunications Arbitration Case 6 (DC PSC Nov. 8, 1996).

<sup>35</sup> See *Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996*, Order No. 12610, Formal Case No. 962 (DC PSC Dec. 6, 2002).

<sup>36</sup> See *Application by Verizon Maryland Inc., Verizon Washington, D.C. Inc., Verizon West Virginia Inc., et al., for Authorization To Provide In-Region, InterLATA Services in Maryland, Washington, D.C., and West Virginia*, Memorandum Opinion and Order, 18 FCC Rcd 5212, ¶ 81 (2003).

effect during the stay include a statewide average loop rate of \$8.49 and a switching rate of \$0.003 per originating and terminating minute.<sup>37</sup>

Washington, D.C. UNE Rates			
	December 1996	December 2002	% reduction
2-wire analog loop (statewide average)	\$10.81	\$4.29	-60%
Local switching (originating per-minute rate)	\$0.003	\$0.00038	-88%

3. In a number of states in Verizon's region, Verizon has been required to reduce its rates to levels that benchmark to the rates set in other states (typically those set in New York or New Jersey). In six states in Verizon's region – New Hampshire, Maryland, West Virginia, Delaware, Rhode Island, and Virginia – Verizon was required during the section 271 process to reduce its rates to levels that satisfy the benchmark test. In California, the state commission has not yet completed a full-scale pricing proceeding to set UNE rates for Verizon, but recently reduced the interim rates that it initially established based on TELRIC costs to benchmark to the rates set in New Jersey.

*New Hampshire.* The New Hampshire PUC initially set UNE rates in July 2001 that it found were TELRIC-compliant.<sup>38</sup> The PUC established a statewide average loop rate of \$18.56 and an average switching rate of \$0.003171 per minute.<sup>39</sup> In June 2002, while the state 271 proceeding was still underway, Verizon was required to reduce these rates in order to meet the FCC's benchmarking standard to a statewide average loop rate of \$16.21 and to an average switching rate of \$0.002379 per minute.<sup>40</sup>

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<sup>37</sup> See Order Approving Amended Interconnection Agreement, Order No. 12641, Formal Case No. TIA 99-10 (DC PSC Jan. 24, 2003), *attached to* Ex Parte Letter from Ann Berkowitz, Verizon, to Marlene Dortch, FCC, WC Docket No. 02-384 (Jan. 24, 2003).

<sup>38</sup> See *Petition for Approval of Statement of Generally Available Terms Pursuant to the Telecommunications Act of 1996*, Order Granting in Part and Denying in Part at 5-6, DE 97-171, Order No. 23,738 (NH PUC filed July 6, 2001) ("Our analysis of the pricing proposals in this docket is premised on a forward-looking economic cost methodology, as set forth in the [Telecommunications Act of 1996] and now interpreted in Iowa III [*Iowa Utilities Board, et al. v. FCC*, 219 F.3d 744 (8th Cir. July 18, 2000)]. Thus, it is calculated to reflect the ILEC's actual incremental costs in the future to serve competitors with the ILEC's network facilities, including whatever upgrades the ILEC chooses to implement").

<sup>39</sup> The rate is a weighted average of daytime, evening, and night rates of \$0.003233, \$0.004285, and \$0.001763, respectively.

<sup>40</sup> See Letter from New Hampshire PUC to J. Michael Hickey, President, Verizon New England at 2, *Application of Verizon New England Inc., d/b/a Verizon New Hampshire, for a Favorable Recommendation to Offer InterLATA Service under 47 U.S.C. 271*, DT 01-151 (NH PUC June 14, 2002). The rate is a weighted average of daytime, evening, and night rates of \$0.002425, \$0.003199, and \$0.001343, respectively.

New Hampshire UNE Rates			
	July 2001	June 2002	% reduction
2-wire analog loop (statewide average)	\$18.56	\$16.21	-13%
Local switching (average per-minute rate)	\$0.003171	\$0.002379	-25%

*Maryland.* The Maryland PSC initially set UNE rates in July 1998 that it found were TELRIC-compliant.<sup>41</sup> The PSC established a statewide average loop rate of \$14.50 and a switching rate of \$0.0038 per originating and terminating minute. In December 2002, while Verizon was preparing to file its section 271 application with the FCC, the Maryland PSC required Verizon to agree to reduce its loop rate to \$12.<sup>42</sup> In addition, Verizon was required to reduce its average switching rate in order to meet the FCC's benchmarking standard to \$0.001676 per originating and terminating minute. The Maryland PSC also is in the process of establishing new UNE rates in a proceeding that is still underway.<sup>43</sup>

Maryland UNE Rates			
	July 1998	December 2002	% reduction
2-wire analog loop (statewide average)	\$14.50	\$12.00	-17%
Local switching (originating per-minute rate)	\$0.0038	\$0.001676	-56%

*West Virginia.* The West Virginia PSC initially adopted UNE rates in April 1997 that it found were TELRIC-compliant.<sup>44</sup> The PSC established a statewide average loop rate of \$24.58

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<sup>41</sup> See *Petitions for Approval for Agreements and Arbitration of Unresolved Issues Arising under § 252 of the Telecommunications Act of 1996*, Order No. 74365, Case No. 8731, Phase II (MD PSC July 2, 1998); *Petitions for Approval for Agreements and Arbitrations of Unresolved Issues Arising under § 252 of the Telecommunications Act of 1996*, Order No. 73707, Case No. 8731, Phase II at 6 (MD PSC Sept. 22, 1997) (“The expert economic witnesses in this case generally agree that [TELRIC] should be used to set the prices for network elements in this proceeding.”).

<sup>42</sup> See Letter from Catherine I. Riley, *et al.*, Maryland PSC, to William R. Roberts, President – Verizon Maryland, Inc. (Dec. 16, 2002).

<sup>43</sup> *Investigation into Recurring Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, Case No. 8879.

<sup>44</sup> See *Bell Atlantic-West Virginia, Inc., Petition To Establish a Proceeding To Review the Statement of Generally Available Terms and Conditions Offered by Bell Atlantic in Accordance with Sections 251, 252, and 271 of the Telecommunications Act of 1996*, Order, Case No. 96-1516-T-PC (WV PSC Apr. 21, 1997); *Bell Atlantic-West Virginia, Inc., Petition To Establish a Proceeding To Review the Statement of Generally Available Terms and Conditions Offered by Bell Atlantic in Accordance with Sections 251, 252, and 271 of the Telecommunications Act of 1996*, Order at 9, Case No. 96-1516-T-PC (WV PSC Oct. 31, 1997) (concluding that the rates Verizon had adopted pursuant to the PSC's earlier orders “were based upon TELRIC-compliant cost studies”). The West Virginia PSC approved Verizon's revisions to its Statement of Generally Available Terms and Conditions, reflective of the April 21, 1997 Order, on April 16, 1999. See *Petition To Establish a Proceeding to Review the Statement of Generally Available Terms and Conditions Offered by Bell Atlantic in Accordance with Sections 251, 252 and 271 of the Telecommunications Act of 1996*; *Petition for Arbitration of Unresolved Issues from the Interconnection Negotiations between AT&T and Bell Atlantic*; *Petition for Initiation of Proceeding Pursuant to Section 271 of the*



and a switching rate of \$0.008868 per originating minute and \$0.005622 per terminating minute. In October 2002, during the course of the section 271 proceeding in West Virginia, Verizon entered into a Joint Stipulation with the Staff of the West Virginia PSC that required Verizon to reduce its statewide average loop rate and its switching rates to meet the FCC's benchmarking standard.<sup>45</sup> The new statewide average loop rate is \$20.41 and the new switching rate is \$0.002586 per originating minute and \$0.002505 per terminating minute.

West Virginia UNE Rates			
	April 1999	December 2002	% reduction
2-wire analog loop (statewide average)	\$24.58	\$20.41	-17%
Local switching (originating per-minute rate)	\$0.008868	\$0.002586	-71%

*Delaware.* The Delaware PSC adopted initial rates for UNEs in July 1997 that it found were TELRIC-compliant.<sup>46</sup> The PSC established a statewide average loop rate of \$12.03 and a switching rate of \$0.003634 per originating minute and \$0.001927 per terminating minute. In August 2002, while Verizon's section 271 application for Delaware was pending before the FCC, Verizon was required to reduce the switching rates in Delaware to meet the FCC's benchmarking standard to \$0.002507 per originating minute and \$0.001330 per terminating minute.<sup>47</sup>

Delaware UNE Rates			
	July 1997	August 2002	% reduction
2-wire analog loop (statewide average)	\$12.03	\$12.03	n/a
Local switching (originating per-minute rate)	\$0.003634	\$0.002507	-31%

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*Telecommunications Act of 1996*, Commission Order, Case Nos. 96-1516-T-PC, 96-1561-T-PC, 96-1009-T-PC (Apr. 16, 1999).

<sup>45</sup> See Joint Stipulation and Agreement for Settlement, *Inquiry into Verizon West Virginia Inc.'s Compliance with the Conditions Set Forth in 47 U.S.C. § 271(c)*, Case No. 02-0809-T-P (WV PSC filed Oct. 15, 2002); *Petition for Declaratory Ruling That Pricing of Certain Additional Unbundled Network Elements (UNEs) Complies with Total Element Long-Run Incremental Cost (TELRIC) Pricing*, Commission Order, Case No. 01-1696-T-PC (WV PSC Dec. 18, 2002).

<sup>46</sup> See *Application of Verizon Delaware, Inc. for Approval of Its Statement of Terms and Conditions under Section 252(f) of the Telecommunications Act of 1996*, Findings, Opinion & Order No. 4542, Docket No. 96-324 (DE PSC July 8, 1997); *id.* at 50 (adopting "as appropriate for determining the justness and reasonableness of SGAT rates in Delaware the FCC's Total Element Long Incremental Cost ('TELRIC') pricing methodology.")).

<sup>47</sup> See Letter from Julia A. Conover, Verizon Vice President and General Counsel – Delaware, to Delaware Public Service Commission Secretary Karen Nickerson, *Inquiry into Verizon Delaware Inc.'s Compliance with the Conditions Set Forth in 47 U.S.C. § 271(c)*, Docket No. 02-001 (Aug. 30, 2002).

*Rhode Island.* The Rhode Island PUC established initial UNE rates in May 2001.<sup>48</sup> It set the statewide average loop rate at \$13.93 and the average switching rate at \$0.009134 per minute.<sup>49</sup> In February 2002, while Verizon's section 271 application for Rhode Island was pending before the FCC, Verizon was required to reduce the switching rates in Rhode Island to meet the FCC's benchmarking standard to \$0.001358 per originating minute and \$0.001192 per terminating minute.<sup>50</sup> The Rhode Island PUC also is now in the process of establishing new UNE rates.

<b>Rhode Island UNE Rates</b>			
	<b>May 2001</b>	<b>February 2002</b>	<b>% reduction</b>
2-wire analog loop (statewide average)	\$13.93	\$13.93	n/a
Local switching	\$0.009134 (average rate/min.)	\$0.001358 (originating rate/min.)	-86%

*Virginia.* In Virginia, the state commission set permanent UNE rates for the first time in April 1999.<sup>51</sup> It set a statewide average loop rate of \$13.76 and a switching rate of \$0.004129 per originating minute and \$0.002079 per terminating minute. In October 2002, while Verizon's section 271 application for Virginia was pending before the FCC, Verizon was required to reduce the switching rates in Virginia to meet the FCC's benchmarking standard to \$0.002643 per originating minute and \$0.001331 per terminating minute.<sup>52</sup> In addition, the FCC is now in the process of establishing new UNE rates in Virginia in the Virginia arbitration proceeding.<sup>53</sup>

<b>Virginia UNE Rates</b>			
	<b>April 1999</b>	<b>October 2002</b>	<b>% reduction</b>
2-wire analog loop (statewide average)	\$13.76	\$13.76	n/a
Local switching (originating per-minute rate)	\$0.004129	\$0.002643	-36%

<sup>48</sup> See *Total Element Long Run Incremental Cost - Final Rates for Verizon-Rhode Island*, Order, Docket No. 2681 (RI PUC May 18, 2001).

<sup>49</sup> The rate is a weighted average of peak and off-peak rates of \$0.011490 and \$0.003890, respectively.

<sup>50</sup> See *Application by Verizon New England Inc., et al., for Authorization To Provide In-Region, InterLATA Services in Rhode Island*, Memorandum Opinion and Order, 17 FCC Rcd 3300, ¶ 26 (2002).

<sup>51</sup> See *Ex Parte: To Determine Prices Bell Atlantic-Virginia, Inc. Is Authorized To Charge Competitive Local Exchange Carriers in Accordance with the Telecommunications Act of 1996 and Applicable State Law*, Final Order, Case No. PUC970005 (VA SCC Apr. 15, 1999).

<sup>52</sup> See *Ex Parte Letter from Ann D. Berkowitz, Verizon Project Manager – Public Affairs to Marlene Dortch, Secretary – Federal Communications Commission, Application by Verizon for Authorization To Provide In-Region, InterLATA Services in State of Virginia*, WC Docket No. 02-214 (Oct. 3, 2002).

<sup>53</sup> *Petition of WorldCom, Inc., for Preemption of Jurisdiction of the Virginia State Corporation Commission Pursuant to Section 252(e)(5) of the Telecommunications Act of 1996 and for Arbitration of Interconnection Disputes with Verizon-Virginia, Inc.*, CC Docket No. 00-218.

*California.* The California PUC initially established interim UNE rates for Verizon consistent with the FCC's rules in an arbitrated agreement with AT&T in January 1997.<sup>54</sup> The PUC established a statewide average loop rate of \$16.81 and a switching rate of \$0.003629 per originating and terminating minute. In March 2003, the PUC adopted new interim rates based on Verizon's rates in New Jersey.<sup>55</sup> Pursuant to that decision, the new statewide average loop rate is \$11.62 and the switching rate is \$0.001457 per originating and terminating minute. These rates are subject to true-up pending the adoption of permanent rates. The PUC is expected to begin a new pricing proceeding to establish permanent rates in August 2003.

California UNE Rates			
	January 1997	March 2003	% reduction
2-wire analog loop (statewide average)	\$16.81	\$11.62	-31%
Local switching (originating per-minute rate)	\$0.003629	\$0.001457	-60%

4. Rates in states outside of Verizon's region also have systematically ratcheted down. *See* Table 2. Since the beginning of 2002 alone, UNE-P rates have decreased by more than 30 percent in Arizona, Indiana and California; by more than 20 percent in Idaho, Wisconsin, Utah and Kentucky; and between 17 and 20 percent in Iowa, Georgia, Washington, Illinois, North Dakota and Nebraska.<sup>56</sup> Data on recent levels of UNE rates collected by the National Regulatory Research Institute show that from January 2002 to January 2003, the national average UNE-P rate dropped 15 percent, while the average loop rate dropped more than 8 percent.<sup>57</sup>

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<sup>54</sup> *See* *Petition of AT&T Communications of California, Inc. for Arbitration Pursuant to Section 252 of the Federal Telecommunications Act of 1996 To Establish an Interconnection Agreement with GTE California, Incorporated*, Opinion Approving Arbitrated Agreement, Application No. 96-08-041, Decision No. 97-01-022 (CA PUC Jan. 13, 1997); *Rulemaking on the Commission's Own Motion To Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Interim Opinion Adopting in Part and Ordering Modifications to Round I and II Cost Studies Submitted by Pacific Bell and GTE California Incorporated, Decision No. 96-08-021, R.93-04-003 (CA PUC Aug. 2, 1996); *see also* *Rulemaking on the Commission's Own Motion To Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Opinion, Decision No. 98-12-079, *Opinion*, R.93-04-003 (CA PUC Dec. 17, 1998) (adopting nonrecurring UNE costs); *Rulemaking on the Commission's Own Motion To Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Order Granting Limited Rehearing to Modify Decision (D.) 98-12-079 and Denying Rehearing of Modified Decision, Decision No. 99-06-060, R.93-04-003 (CA PUC June 10, 1999) (modifying nonrecurring UNE costs).

<sup>55</sup> *See* *Rulemaking on the Commission's Own Motion To Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Interim Opinion Establishing Interim Rates for Network Elements of Verizon California, Modifying Interim Price Floor Formula Adopted in Decision 99-12-018, and Adopting Nonrecurring Prices, Decision No. 03-03-033, R.93-04-003 (CA PUC Mar. 13, 2003).

<sup>56</sup> *See* M. Bartlett, *et al.*, Banc of America, *UNE-P Competition: Assessing RBOC Vulnerability* at 7 (Feb. 27, 2003); *Merrill Lynch Telecommunicator Comment* at 19.

<sup>57</sup> *See* Billy Jack Gregg, *A Survey of Unbundled Network Elements in the United States*, National Regulatory Research Institute (July 2002 & Jan. 2003).

<b>Table 2. Rate Reductions Outside of Verizon's Region January 2002 through January 2003</b>			
<b>State</b>	<b>UNE-P</b>	<b>State</b>	<b>UNE-P</b>
Arizona	-37%	Nebraska	-17%
Indiana	-34%	Montana	-15%
California	-32%	Alabama	-14%
Idaho	-23%	Florida	-13%
Wisconsin	-23%	Wyoming	-13%
Utah	-22%	Louisiana	-11%
Kentucky	-22%	New Mexico	-9%
Iowa	-20%	North Carolina	-8%
Georgia	-20%	South Carolina	-8%
Washington	-19%	Tennessee	-6%
Illinois	-19%	Mississippi	-4%
North Dakota	-19%	Oklahoma	-3%
<i>Sources: M. Bartlett, et al., Banc of America, UNE-P Competition: Assessing RBOC Vulnerability at 7 (Feb. 27, 2003); Merrill Lynch Telecommunicator Comment at 22.</i>			

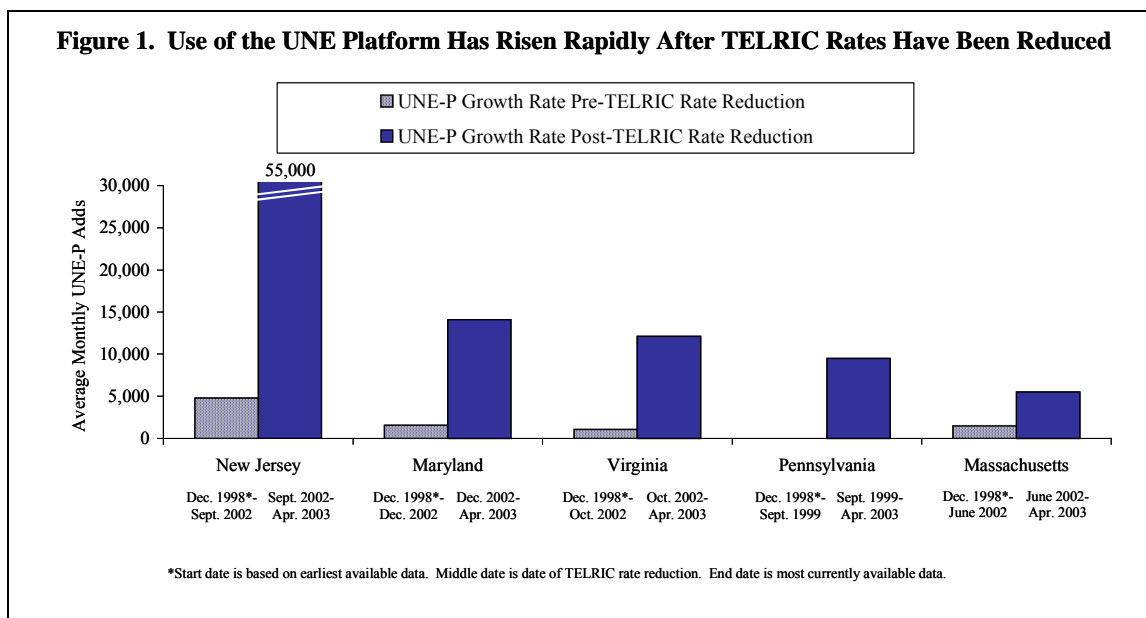
**B. The Negative Effect of the UNE Platform at TELRIC Rates on Investment and Facilities-Based Competition.**

As TELRIC rates have been ratcheted down, the use of the UNE platform has exploded. This has led to a significant decrease in investment in the telecommunications industry, both by incumbents and competing carriers. Competitors have significantly curtailed the use of their existing facilities to serve customers and have begun to rely instead on the TELRIC-priced UNE-P. This shift from facilities-based competition to the UNE-P is now occurring even for customers that competitors have traditionally served using their own facilities. And while the main UNE-P carriers have argued that the widespread use of the UNE-P ultimately would lead to facilities-based competition, these carriers have failed to migrate customers to their own facilities and now openly tout the fact that they don't need to make *any* investment to reap large margins. In fact, the arbitrage opportunity TELRIC has created is so great that it has even spawned the creation of a cottage industry dedicated to helping companies use the UNE-P to earn large margins without making any investment.

1. *As TELRIC rates have been ratcheted down, the use of the UNE platform has exploded.* According to the FCC's most recent local competition report, since the beginning of 2000 – which is to say, since TELRIC rates have been reduced in most states – the total number of UNE-P lines nationwide has grown from fewer than 500,000 to more than 10 million, an increase of approximately 2,000 percent.<sup>58</sup> And although the FCC's report does not provide totals of UNE-P lines by state, Verizon's state-specific data demonstrate that the rise of UNE-P is directly traceable to the lowering of TELRIC rates. For example, the average number of lines that competitors are adding monthly using UNE-P has grown by more than 1,000 percent in New

<sup>58</sup> See Ind. Anal. & Tech. Div., FCC, *Local Telephone Competition: Status as of December 31, 2002* at Table 4 (June 2003) (“2002 Local Competition Report”).

Jersey, Pennsylvania, and Virginia, by more than 800 percent in Maryland, and by more than 250 percent in Massachusetts, in the periods following rate reductions in those states. See Figure 1.



2. As use of the UNE-P at TELRIC rates has increased, investment by all telecom carriers, incumbent LECs and competing carriers alike, has declined significantly. See Figure 2. According to a recent report by Skyline Marketing Group, between 2000 and 2002, overall investment by wireline telecommunications carriers declined from \$104.8 billion to \$42.8 billion – a reduction of over \$60 billion in just two years.<sup>59</sup> See Figure 2. According to UBS Warburg, Bell company capital expenditures fell 4 percent from 2000 to 2001, and 35 percent from 2001 to 2002.<sup>60</sup> According to ALTS, capital expenditures by competitive telecom carriers decreased by 19 percent and 56 percent, respectively, over those same periods.<sup>61</sup> Analysts also expect further declines in 2003. Lehman Brothers reports that total capital spending in the telecom sector is expected to fall another 15 percent in 2003.<sup>62</sup> The *Wall Street Journal* recently reported that “spending on equipment by the six major telecom operators that have reported was down an average of 19% in the first quarter [of 2003] compared with the same period the year before, widely considered to be the worst year in the telecom industry’s history.”<sup>63</sup>

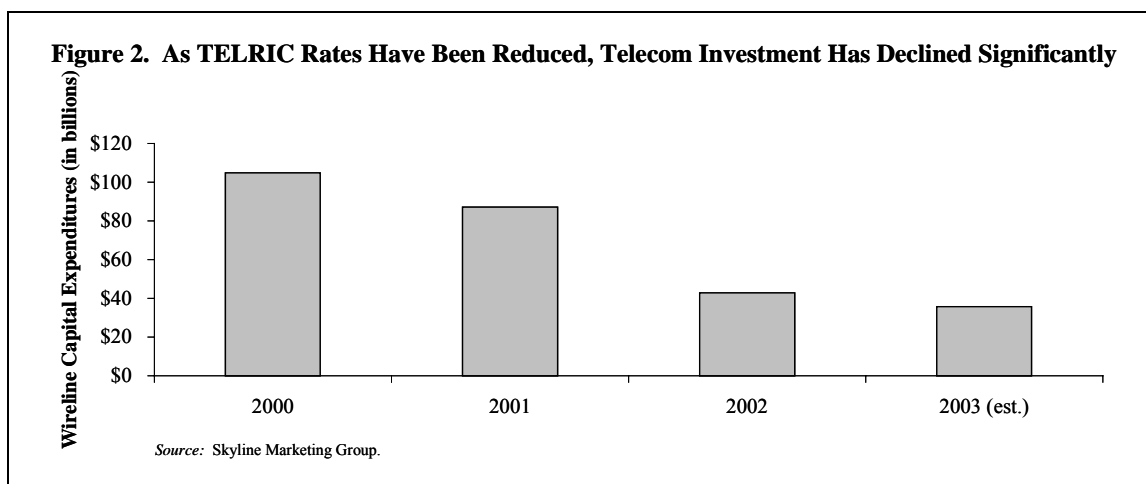
<sup>59</sup> See Skyline Marketing Group, *CapEx Report: 2002 Annual Report*, Carrier Data Sheet 1 (June 2003); see also TIA, *2003 Telecommunications Market Review and Forecast* at 56 – Tables II-4.1 & II-4.2 (2003) (Spending by carriers on telecommunications equipment decreased by 26.2 percent in 2001 (from \$58B to \$43B) and by 49.1 percent in 2002 (from \$43B to \$22B)).

<sup>60</sup> J.C. Hodulik, et al., UBS Warburg, *Are the Bells Growing Less Profitable* at 41 (Apr. 16, 2003).

<sup>61</sup> ALTS, *The State of Local Competition 2003* at 10 (Apr. 2003) (“ALTS 2003 Report”).

<sup>62</sup> S. Levy, et al., Lehman Brothers, Inc. Investext Rpt No. 7398937, *Spenders & Vendors – Steady as She Goes: March Quarter Spendin* at \*4 (May 19, 2003).

<sup>63</sup> A. Latour, et al., *A Wrong Number for Telecom: Big Operators Cut Spending 19%*, Wall St. J. (Apr. 28, 2003).



The decline in telecom investment has significant ramifications for the United States economy as a whole, because the telecom sector accounts for a substantial share of all capital spending in the U.S. At its peak in the year 2000, the telecom sector as a whole was investing about \$110 billion per year, and thus accounted for about 10 percent of all annual capital spending in the United States.<sup>64</sup> But the TELRIC and UNE-P rules have so significantly devalued the telecom sector that this level of investment is no longer sustainable. As Scott Cleland of the Precursor Group has concluded, “the macroeconomic consequences of the FCC’s TELRIC fiat was to devalue three quarters of the Nation’s telecom infrastructure by two-thirds.”<sup>65</sup> Indeed, the market capitalization of the telecommunications and equipment manufacturing sectors has declined by some \$2 trillion since 2000.<sup>66</sup> Chairman Powell himself has recognized this decline.<sup>67</sup>

3. *In addition to reducing investment, competitors also have significantly curtailed the use of even their existing facilities and are relying instead on the UNE platform.* This is evident from the recent decrease in the use of CLECs’ own existing switching facilities to serve customers. For example, in just eight of the states where carriers now make extensive use of the UNE-P, competing carriers connected more than 55,000 fewer lines per month in 2002 to their own switches using unbundled loops than they did in 2000 – a difference of more than 600,000

<sup>64</sup> U.S. Census Bureau, *Annual Capital Expenditures: 2001* at 10-11 (Jan. 2003).

<sup>65</sup> *Hearings before the Subcommittee on Telecommunications Trade & Consumer Protection of the House Commerce Comm.*, 106th Cong. 2 (May 25, 2000) (Written statement of Scott Cleland, Managing Director, The Precursor Group).

<sup>66</sup> See, e.g., S. Rosenbush, *et al.*, *Inside the Telecom Game*, Business Week (Aug. 5, 2002) (“Investors have lost some \$2 trillion [in telecom] as stock prices have tumbled 95% or more from their highs.”); P. Starr, *The Great Telecom Implosion*, The American Prospect (Sept. 9, 2002) (“Out of the \$7 trillion decline in the stock market since its peak, about \$2 trillion have disappeared in the capitalization of telecom companies.”).

<sup>67</sup> See *The Financial Turmoil in the Telecommunications Marketplace; Maintaining the Operations of Essential Communications Facilities*, Hearing of the United States Senate Committee on Commerce, Science, and Transportation, Washington, D.C. (July 30, 2002) (Testimony of FCC Chairman Michael Powell: “This is an industry where . . . approximately \$2 trillion of market value has been lost in the last 2 years.”).

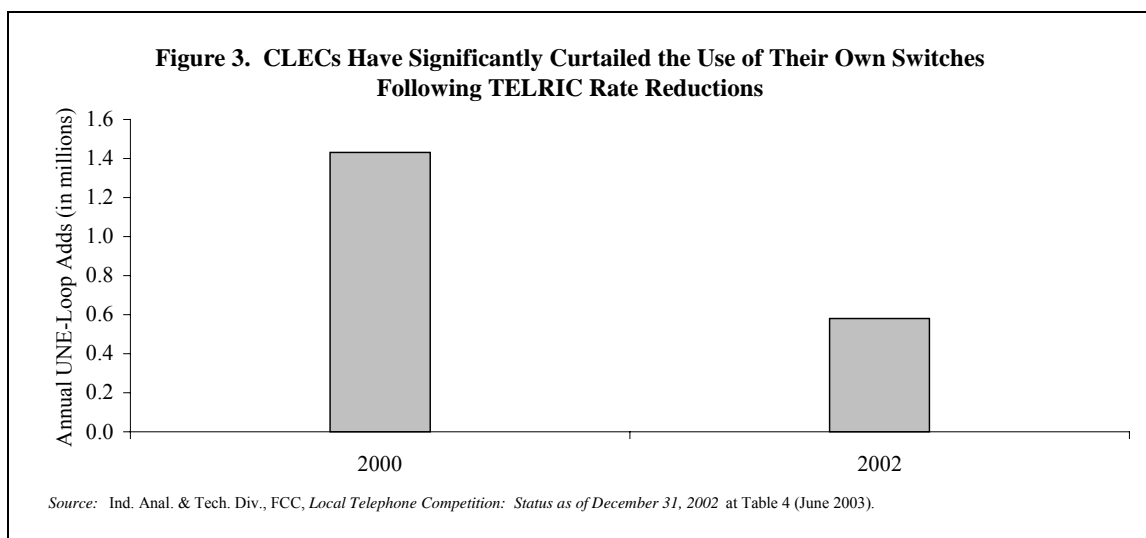
fewer lines over the course of the year. *See* Table 3.<sup>68</sup> Data compiled by the FCC for all states show the same trend. *See* Figure 3. During this same time period, the number of UNE-P lines nationwide increased by approximately 2,000 percent, from roughly half a million to more than 10 million.<sup>69</sup> And this trend is only increasing. Indeed, in the Verizon states where the rise of UNE-P began the earliest – New York and Pennsylvania – the average number of lines added monthly using CLEC switches with unbundled loops declined by 50 percent in the first year after the rise of UNE-P (2000-2001) and by 60 percent in the second year. Whereas competitors in those two states were obtaining an average of 26,000 lines monthly in 2000 using their own switches together with unbundled loops, that figure has declined to less than 5,000 today. Outside of Verizon's region, the story is the same: from the beginning of 2001 through the end of 2002, the average number of new lines that CLECs added monthly using their own switches together with unbundled loops declined by 120 percent in BellSouth's region, and by more than 70 percent in SBC's region.<sup>70</sup>

<b>Table 3. The Declining Use of CLEC Switches Together with Unbundled Loops</b>			
	<b>Average Monthly UNE-Loop Net Adds</b>		
	<b>2000</b>	<b>2002</b>	<b>Change (2000-2002)</b>
New York	12,590	3,800	-70%
New Jersey	2,169	285	-87%
Massachusetts	4,439	616	-86%
Georgia*	2,931	-2,150	-173%
Florida*	5,643	-346	-106%
Illinois**	10,786	2,004	-81%
California**	18,390	3,265	-82%
Texas**	5,740	115	-98%
<b>Eight-State Total</b>	<b>62,688</b>	<b>7,588</b>	<b>-88%</b>
*BellSouth data. **SBC data. <i>Sources: Selected RBOC Local Telephone Data, available at: <a href="http://www.fcc.gov/wcb/iatd/comp.html">http://www.fcc.gov/wcb/iatd/comp.html</a> (RBOC_Local_Telephone_Dec_1999.xls; RBOC_Local_Telephone_Dec_2000.xls; RBOC_Local_Telephone_Dec_2001.xls; RBOC_Local_Telephone_Dec_2002.xls).</i>			

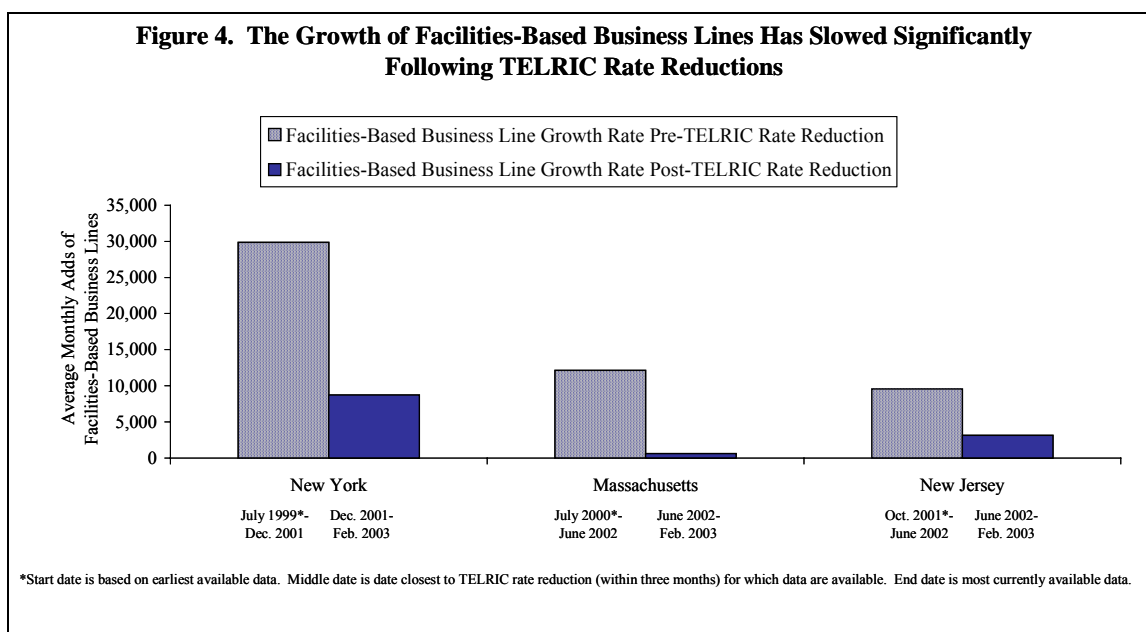
<sup>68</sup> *Selected RBOC Local Telephone Data, available at: <http://www.fcc.gov/wcb/iatd/comp.html> (RBOC\_Local\_Telephone\_Dec\_1999.xls; RBOC\_Local\_Telephone\_Dec\_2000.xls; RBOC\_Local\_Telephone\_Dec\_2001.xls; RBOC\_Local\_Telephone\_Dec\_2002.xls).*

<sup>69</sup> *See 2002 Local Competition Report at Table 4.*

<sup>70</sup> *See Selected RBOC Local Telephone Data, available at: <http://www.fcc.gov/wcb/iatd/comp.html> (RBOC\_Local\_Telephone\_Dec\_2001.xls; RBOC\_Local\_Telephone\_Dec\_2002.xls). Data for SBC exclude Nevada.*



4. *The negative effect of the UNE-P at TELRIC rates on facilities-based competition is now occurring even in business markets, where CLECs once relied almost entirely on their own facilities to serve customers. As the use of the TELRIC-priced UNE-P to serve business customers has rapidly increased, the use of facilities-based alternatives has declined. In New York, for example, the average number of business lines that CLECs have added monthly on their own switching facilities (using either their own loop or an unbundled loop) has declined by more than 70 percent in the period following the most recent rate reduction in that state. See Figure 4. In Massachusetts and New Jersey, the comparable figures are 95 percent and 45 percent, respectively. See id. This has occurred as the use of UNE-P to serve business customers has exploded. For example, between year-end 2001 and February 2003, the percentage of CLEC business lines in Verizon's region served through the UNE-P has more than doubled (from 6 percent to 13 percent).*





5. *Competing carriers are not migrating UNE-P customers to their own facilities and now widely tout the fact that they don't plan to make new investment.* Until very recently, the competing carriers that rely most heavily on TELRIC-priced UNE platforms have argued that policies promoting widespread unbundling and extremely low wholesale rates were necessary to promote facilities-based competition. AT&T stated in early 2002, for example, that “[t]he availability of UNEs will . . . promote facilities-based service for residential customers.”<sup>71</sup> Its rationale was that a CLEC “cannot rationally invest in switches . . . until they have used UNE-P to build up a customer base.”<sup>72</sup>

But the very same carriers who made these arguments have failed to migrate customers to their own facilities, and have even given up the pretense that they will do so. Indeed, the UNE-P carriers now assure investors that their business plans involve little risk because they permit CLECs to compete without making *any* investment in their own competitive facilities. UNE-P at TELRIC rates allows CLECs to avoid “making economic sacrifices” (AT&T); it requires “very little capital” (WorldCom); it “allows us to avoid significant capital investments in network facilities (Z-Tel); it “allows us to earn attractive gross margins” “without the need for costly network infrastructure” (Talk America).<sup>73</sup> Future profitability is assured, these carriers openly boast, by the price gap that regulators will maintain between wholesale and retail rates.<sup>74</sup>

In fact, the arbitrage opportunity TELRIC has created is so great that it even has spawned the creation of a cottage industry of telecom consultants dedicated to helping companies “become a UNE-P CLEC” in order to take advantage of the “50% to 70% Net Profit Available” in an environment where “no equipment investment is required!”<sup>75</sup> One consultant – ISG – informs potential UNE-P carriers that “no switching equipment is required, but instead you lease ports on the ILEC’s switches for a fraction of the cost of purchasing equipment,” which produces

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<sup>71</sup> Comments of AT&T Corp., Inc. at V-VI, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 01-338 (FCC filed Apr. 5, 2002).

<sup>72</sup> Ex Parte Letter from Robert W. Quinn, AT&T, to William F. Caton, FCC, CC Docket No. 01-347 (Mar. 1, 2002).

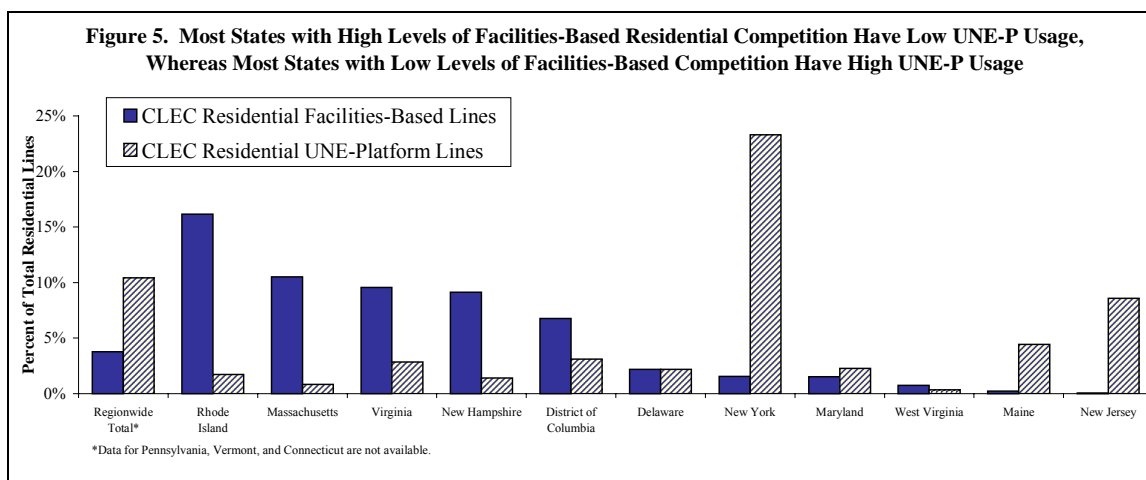
<sup>73</sup> *Q2 2002 AT&T Earnings Conference Call – Final*, Fair Disclosure Wire, Transcript 072302au.729 (July 23, 2002) (AT&T Consumer Services president and CEO Betsy Bernard: UNE-P gives AT&T “unmatched leverage to create offers . . . without making economic sacrifices.”) (“*AT&T 2Q Earnings Conference Call*”); Wayne Huyard, Chief Operating Officer, MCI, *Using UNE-P To Develop a Strong and Profitable Local Presence*, Goldman-Sachs Telecom Issues Conference, New York, NY (May 7, 2002) (WorldCom is “deploying *very little capital*” to provide UNE-P service) (emphasis added); Z-Tel, 2001 Annual Report at ii (“[O]ur UNE-P-based business model allows us to avoid significant capital investments in network facilities.”); Talk America, 2000 Annual Report at 7 (“Talk America can now lease the necessary elements of the Bell network – without the need for costly network infrastructure, which allows us to earn attractive gross margins.”).

<sup>74</sup> See, e.g., *AT&T 2Q Earnings Conference Call* (AT&T Consumer Services President and CEO Betsy Bernard: “[W]e are not going into states where we don’t have a gross margin of 45 percent on the local. That’s kind of our threshold trigger to go in and we are not going to go in on the hope and the prayer that next year or two years from now, the rates may change to make it favorable to the strategy that we’re executing.”).

<sup>75</sup> A+ American Discount Telecom, *50% to 70% Net Profit Available to Competitive Telephone Companies*, <http://a-adt.com> (visited June 3, 2003); see also A+ American Discount Telecom, *The U.S. Supreme Court Wants CLEC’s To Make More Money with UNE-P! You Don’t Need Resale Anymore!*, <http://a-adt.com/une-p-clec.html> (visited June 3, 2003); CLEC Strategies, <http://www.clecstrategies.com>; The Northridge Group, <http://www.northridgegroup.com>.

“profit margins” that “range from 50-90%.”<sup>76</sup> It states that “the BIGGEST benefit with the UNE-P/CLEC arrangement” is the ability to collect access charges from long distance carriers, and provides a “calculator” to let carriers estimate their potential revenue, which it states should average “\$10/month in revenue per line” for the average residential customer, and “\$40/month per line” for the average business customer – enough to “pay their ILEC bills [just with the access charges they receive] and keep all of the revenue they collect from their End Users.”<sup>77</sup> Demand appears to be so high for ISG’s services that it “has had to limit the number of new clients becoming part of our membership group to ten (10), new clients per month.”<sup>78</sup>

Contrary to claims that high levels of UNE-P usage would lead to more facilities-based competition, the opposite is now occurring. For example, the states in Verizon’s region where TELRIC rates have been reduced the most – and which as a result now have the highest levels of residential UNE-P usage – have the lowest levels of facilities-based residential competition. The states with the highest residential UNE-P penetration in Verizon’s region are New York and New Jersey where residential UNE-P lines represent 30 percent and 10 percent of Verizon’s residential lines in those states, respectively. Each of these states has low levels of facilities-based residential lines, which in each case represent 2 percent or less of the total residential lines in the state. *See* Figure 5. Conversely, the level of residential UNE-P is lowest in those residential markets where levels of facilities-based residential competition are relatively high. The four Verizon states with the most facilities-based residential lines in proportion to the BOC access lines in each state are Rhode Island, Massachusetts, Virginia, and New Hampshire. The residential UNE-P penetration in each of these states is among the lowest in Verizon’s region, in each case representing less than 3 percent of the residential access lines in the state. *See id.*



6. *CLECs have not only failed to migrate UNE-P customers to their own facilities, but in a number of instances have done the reverse – moved existing customers from their own*

<sup>76</sup> ISG Telecom, *Revenues for the UNE-P CLEC*, <http://www.isg-telecom.com> (click on link “UNE-P CLEC”).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

*facilities to UNE platforms.* For example, in Verizon's region, between June and September of 2002, nine carriers in four Verizon states (Pennsylvania, New York, Virginia, and Maryland) migrated several hundred business lines from their own facilities to UNE-P.<sup>79</sup> Publicly filed data likewise show that the number of lines that competitors are serving entirely over their own facilities is decreasing at the same time that use of the UNE-P is increasing, which suggests that some carriers have begun to move *existing* customers that they were serving using their own facilities to UNE platform arrangements. According to the FCC's Local Competition Report, the number of "CLEC-owned" lines (*i.e.*, "lines provided over CLEC-owned last-mile facilities") increased from 5.2 million to 6.4 million between December 2000 and December 2002, while the subset of those totals provided through "coaxial cable" (*i.e.*, cable telephony) increased from 1.1 million to 3 million.<sup>80</sup> That means that the number of CLEC-owned lines other than those provided through cable telephony decreased from 4.1 million to 3.4 million during that period, while the number of UNE-P lines increased from 2.8 million to 10.2 million.

### C. The Development of Local Competition.

Today, facilities-based competition increasingly is coming from intermodal sources – such as wireless, cable, and voice over IP networks. These intermodal sources are competing against traditional wireline networks in two significant respects – by taking customer lines, and, even where they do not necessarily take a line, by taking traffic minutes.

Today, a large and growing number of customers are abandoning their wireline phone service for a wireless phone, and an even larger share of traffic minutes are migrating to wireless networks.<sup>81</sup> As Chairman Powell recently found, "much of the most significant competition in voice . . . has come from wireless phone service."<sup>82</sup> The FCC itself has recognized that wireless is now competitive with primary line wireline services for a large and growing segment of the population.<sup>83</sup> A January 2002 *USA Today*/CNN/Gallup poll found that 18 percent of cell phone

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<sup>79</sup> See, e.g., UNE Rebuttal Report 2002 at 31, n.161, *Review of the Section 251 Unbundling Obligation of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, *et al.* (FCC filed Oct. 23, 2002) ("[B]etween June and September of [2002], nine carriers in four Verizon states (Pennsylvania, New York, Virginia, and Maryland) have migrated several hundred business lines from their own facilities to UNE-P. SBC also has begun to receive requests for conversions of UNE-loop lines to the UNE-P."); Letter from William Barr, Verizon, to Michael Powell, FCC, at 17-18, *attached to* Ex Parte Letter from Ann Berkowitz, Verizon, to Marlene Dortch, FCC, CC Docket No. 01-338 (Oct. 16, 2002) ("several carriers (including one of the largest) have sought to move customers off their own switches and on to the UNE-platform.").

<sup>80</sup> See 2002 *Local Competition Report* at Tables 5 & 10; Ind. Anal. Div., FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 5 (May 2001).

<sup>81</sup> See, e.g., C. Govlin, *et al.*, Forrester Research, *Sizing US Consumer Telecom* at 6 (Jan. 2002) ("Lower costs for wireless service, widespread broadband availability, and an absence of fixed-line innovation will flatline the POTS business. A second wave of displacement – pushing voice to broadband networks and making wireless the preferred data channel – will further erode dependence on the original Bell network.").

<sup>82</sup> Michael K. Powell, Chairman, FCC, *Competition Issues in the Telecommunications Industry*, Written Statement before the Committee on Commerce, Science, and Transportation, United States Senate (Jan. 14, 2003).

<sup>83</sup> See *Application by SBC Communications Inc., et al., for Authorization to Provide In-Region, InterLATA Services in Nevada*, Memorandum Opinion and Order, 18 FCC Rcd 7196, ¶ 15 (rel. Apr. 14, 2003) (finding that broadband PCS "represents an actual commercial alternative to [a BOC] for residential telephone exchange services.").

users “use cell phones as their primary phones.”<sup>84</sup> A study by wireless provider Leap Wireless “indicated that 32% of its subscriber base has completely cut their home phones, up from approximately 7% about a year-and-a-half ago.”<sup>85</sup> Another by Merrill Lynch found that “the percentage of wireless subscribers that have completely cut their home phones could be as high as 10% to 15% in some markets.”<sup>86</sup>

Wireless is directly price competitive with wireline services, particularly when the comparison is made between equivalent bundles of service. The typical wireline customer purchases not only basic local service, but also long-distance service and some number of value-added features like call waiting, voice mail, or caller ID.<sup>87</sup> Wireless carriers typically provide all of these add-on services, and often for no extra charge.<sup>88</sup> Taking into account the whole package of service most typically sold, a Gartner Dataquest study concludes that wireless calling prices are already “competitive with, and in some case better than, wireline calling rates.”<sup>89</sup> And wireless prices continue to decline rapidly – by as much as 10 to 20 percent a year in recent years.<sup>90</sup> Wireless service also provides added convenience by virtue of the fact that the wireless phone is mobile. Mobility is, self evidently, a very valuable feature, and one that has historically commanded a high price premium in the market. The attractiveness of wireless bundles has become such a threat to wireline providers that they offer competing bundles of their own.<sup>91</sup> See Table 4.

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<sup>84</sup> M. Kessler, *18% See Cell Phones as Their Main Phones*, USA Today (Jan. 31, 2002).

<sup>85</sup> See L. Mutschler, *et al.*, Merrill Lynch Capital Markets, Investext Rpt. No. 8491558, Wireless Svc: Landline Substitution: Becoming More Meaningful – Industry Report at \*3 (Apr. 22, 2002); see also Leap Wireless Press Release, *Leaping over Landline: Leap Leads Wireline Displacement Trend* (June 24, 2002) (according to a company survey, “more than 26 percent of [] Cricket customers say they do not have a traditional phone at home.”).

<sup>86</sup> L. Mutschler, *et al.*, Merrill Lynch Capital Markets, Investext Rpt. No. 8491558, Wireless Svc: Landline Substitution: Becoming More Meaningful – Industry Report at \*2 (Apr. 22, 2002).

<sup>87</sup> See, e.g., J. Bazinet & D. Pinsker, JP Morgan H&Q, *The Cable Industry* at 50 (Nov. 2, 2001) (the average voice customer generates approximately \$58 in monthly revenues, only \$18 of which is for basic local service; the average revenue generated for vertical features is nearly \$5, and the average revenue generated in access charges is about \$5.50).

<sup>88</sup> See, e.g., Sprint PCS, *Sprint PCS Wireless Service Plans*, <http://www1.sprintpcs.com/explore/servicePlansOptionsV2/PlansOptions.jsp> (all Sprint PCS service plans include voicemail, call waiting, caller ID, numeric paging, and three way calling.); T-Mobile, *Plans*, <http://www.t-mobile.com/plans/default.asp> (all T-Mobile plans include voicemail, call waiting, caller ID, built-in paging, and conference calling).

<sup>89</sup> P. Schoener & A. Sabia, Gartner, *U.S. Consumer Telecommunications and Online Market, 2001* at 33 (Nov. 8, 2001).

<sup>90</sup> See, e.g., *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993*, Sixth Report at 6, FCC 01-192 (rel. July 17, 2001).

<sup>91</sup> See, e.g., Verizon Press Release, *Verizon Revolutionizes Communications Service for Consumers with One Package, One Call, One Bill for Local, Long-Distance, DSL and Wireless* (Aug. 6, 2002) (Verizon’s “Variations” offering); SBC Communications Press Release, *SBC Connections Strategy “Rewards” Consumers With Comprehensive, Next-generation Bundles Featuring More Savings, Convenience, Choices* (Nov. 18, 2002) (SBC’s “Total Connections” offering); BellSouth, *Residential Services, BellSouth Answers*, <http://www.bellsouth.com/consumer/answers/index.html?EC>; BellSouth Press Release, *Customers Enjoy More Choice and Savings from One Provider, with New BellSouth® Answers Packages* (July 29, 2002) (BellSouth’s “Answers” offering).

**Table 4. Examples of Bundled Service Offerings**

	<b>Verizon Freedom (D.C.)</b>	<b>RCN/ Starpower Ultra Feature</b>	<b>Cingular Preferred Nation 500 w/ Rollover</b>	<b>AT&amp;T mLife National Next Generation</b>	<b>Sprint PCS Free and Clear</b>	<b>T-Mobile Get More (National)</b>
Price per Month	\$49.95	\$47.79	\$49.99 for 500 anytime, and 5,000 night/weekend minutes	\$49.99 for 700 anytime minutes	\$45.99 for 500 anytime, and unlimited night/weekend minutes	\$39.99 for 600 anytime, and unlimited night/weekend minutes
Local	Yes – Unlimited	Yes – Unlimited	Yes	Yes	Yes	Yes
Local Toll	Yes – Unlimited	Yes – Unlimited	Yes	Yes	Yes	Yes
Long Distance	Yes – Unlimited	Yes – Unlimited	Yes	Yes	Yes	Yes
Vertical Services	Yes (4 plus voicemail)	Yes (8 plus voicemail)	Yes (4 plus voicemail)	Yes (6 plus voicemail)	Yes (3 plus voicemail and numeric paging)	Yes (4 plus voicemail and 50 incoming text messages)

Wireless substitution is even greater in terms of the amount of traffic that is migrating from wireline to wireless networks. Analysts have estimated that wireless traffic has displaced 30 percent of total wireline minutes.<sup>92</sup> This trend is accelerating as wireless minutes of traffic are growing much faster than wireline minutes.<sup>93</sup> Lehman Brothers estimates that wireless accounted for 30 percent of total telecom sector revenue in 2002, up from 5 percent in 1996.<sup>94</sup> By 2006, a Yankee Group study predicts, U.S. mobile subscribers will increase by 50 percent and will “dominate personal calling and severely cannibalize landline minutes of use.”<sup>95</sup>

Cable operators also are competing with ILECs in the provision of telephony services. See Table 5. At least four incumbent cable operators – Comcast, Cox, Cablevision and Insight – have deployed commercial circuit-switched cable telephony in 20 states.<sup>96</sup> This service relies on

<sup>92</sup> See *FCC Reports Wireless Sub Growth is Leveling, Mobile is on Rise*, Communications Daily (June 27, 2003).

<sup>93</sup> P. Cusick, *et al.*, Bear, Stearns & Co., Inc., Investext Rpt. No. 7397790, Non-Public Operators Steal the Show . . . Again – Industry Report at \*7 (May 20, 2003) (“For the next year we are looking for [wireless] minute-usage growth of 16% per user, and 26% overall as more customers are added and more telecom minutes are migrated to wireless.”); *3g Rollouts Inch Along, But Kagan Research Indicates Wireless Minutes Roaring Ahead, Set to Dominate Telecom Landscape by 2005 Leading Executives to Debate Market Demand, Technology and Financing at Kagan’s Wireless Telecom Summit May 2-3 in New York*, Bus. Wire (Apr. 27, 2001) (landline minutes growing in “low single digits”); See also P. Cusick, *et al.*, Bear, Stearns & Co., Inc., Investext Rpt. No. 7393872, Wireless Services – Searching for the Catalysts – Industry Report at \*31 (May 13, 2003) (expecting “increasing minute usage as the wireline-wireless cannibalization continues.”).

<sup>94</sup> See *FCC Reports Wireless Sub Growth is Leveling, Mobile is on Rise*, Communications Daily (June 27, 2003).

<sup>95</sup> Yankee Group News Release, *Consumers Abandon Landlines and Increase Mobile Call Volumes, Creating Strong Growth in the Wireless Market*, Reports Yankee Group (Sept. 16, 2002).

<sup>96</sup> See M. Stump and K. Brown, *Comcast Plunges Into Telephony*, Multichannel News at 5 (Dec. 24, 2001); *Cabling Home*, Nashville Bus. J. at 17 (Feb. 1, 2002); *Annual Assessment of the Status of Competition in the Market*

the same kind of circuit switches that ILECs use to provide service, plus the cable operator's own network for both loop and transport.<sup>97</sup> This service is now available to more than 15 million U.S. homes – approximately 15 percent of the mass market.<sup>98</sup> Approximately 3 million homes currently subscribe.<sup>99</sup> And cable operators are adding tens of thousands of new subscribers each month.<sup>100</sup>

<b>Table 5. Examples of Cable Telephony Offerings in Verizon's Region</b>					
	<b>Time Warner Digital Phone</b>	<b>Comcast DTS Time Saver</b>	<b>Cox Connection 200</b>	<b>Cablevision Optimum Voice</b>	<b>RCN/Starpower Ultra Feature</b>
Service Area	Maine	Northern VA; Prince Georges County, MD	Rhode Island	Long Island, NY	Washington, DC
Features	Unlimited local, local toll, and long distance; 3 vertical services	Unlimited local service; 7 vertical services	Unlimited local service; 200 local toll or long distance minutes; 4 vertical services	Unlimited local, local toll, and long distance; 5 vertical services	Unlimited local, local toll, and long distance; 8 vertical services plus voicemail
Price per Month	\$39.95	\$31.55	\$36.90	\$34.95	\$47.79

Cable telephony is already ubiquitous in some states, such as Rhode Island, where Cox has the “capability to provide cable telephony service to 75 to 95 percent of Rhode Island customers.”<sup>101</sup> Comcast offers cable telephony services to large fractions of the nearly three

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for the Delivery of Video Programming, Ninth Annual Report, 17 FCC Rcd 26901 (2002) (“*Ninth Video Competition Report*”); T. Kerver, *Operator of the Year*, Cablevision (Oct. 22, 2001). There currently are two major cable operators – AT&T and Cox – and a third smaller one, Insight, that are actively deploying circuit-switched cable telephony to new areas. See Yahoo! Business, *AT&T and Comcast Remain On Watch Neg* (Dec. 20, 2001), [http://biz.yahoo.com/bw/011220/202353\\_1.html](http://biz.yahoo.com/bw/011220/202353_1.html); K. Darce, *Local Phone Arena Gets New Players*, Times-Picayune at 1 (Feb. 8, 2002); Insight Communications, *Services*, <http://www.insight-com.com/services/>.

<sup>97</sup> See *Ninth Video Competition Report*, ¶¶ 49-51.

<sup>98</sup> Comcast Press Release, *Comcast Full Year and Fourth Quarter Results Meet or Exceed All Operating and Financial Goals* (Feb. 27, 2003); Cox Communications Press Release, *Cox Communications Announces Fourth Quarter Financial Results for 2002; Strong Demand for Cox's Digital Services Builds Solid Foundation for Continued Growth in 2003* (Feb. 12, 2003); Cablevision Systems Press Release, *Cablevision Systems Corporation Reports Fourth Quarter 2002 Financial Results* (Feb. 11, 2003); RCN Press Release, *RCN Announces Fourth Quarter and Year-End 2002 Results* (Mar. 13, 2003); Charter Press Release, *Charter Announces 2002 Operating Results and Restated Financial Results for 2001 and 2000; Company Will Extend Filing of Form 10-K* (Apr. 1, 2003); Insight Communications Press Release, *Insight Communications Announces Fourth Quarter and Year-End 2002 Results* (Feb. 25, 2003); Knology, Inc., Form 10-K (SEC filed Mar. 31, 2003).

<sup>99</sup> *2002 Local Competition Report* at Table 5.

<sup>100</sup> Reply to Comments and Petitions to Deny Applications for Consent to Transfer Control at 11, *Applications for Consent to the Transfer of Control of Licenses Comcast Corp. and AT&T Corp., Transferors, to AT&T Comcast Corporation, Transferee*, MB Docket No. 02-70 (FCC filed May 21, 2002) (“AT&T Broadband is capable of serving approximately seven million households, has enrolled over 1.15 million cable telephony customers, and is adding approximately 40,000 customers per month.”).

<sup>101</sup> See, e.g., *Application by Verizon New England Inc., et al., for Authorization To Provide In-Region, InterLATA Services in Rhode Island*, Memorandum Opinion and Order, 17 FCC Rcd 3300, ¶ 105 (2002).

million homes its cable network passes in the Boston Area,<sup>102</sup> the approximately 600,000 homes it passes in the Pittsburgh area,<sup>103</sup> the 3.5 million homes it passes in the Chicago area,<sup>104</sup> and the 2.7 million homes it passes in the Bay Area.<sup>105</sup> Cox and Comcast boast that they have achieved penetration rates of as high as 40 percent in the most mature markets, and 20 percent or more in even the less mature ones.<sup>106</sup> Cox reportedly earned margins of 35 percent from the provision of cable telephony in 2002 (and as high as 38 percent in the fourth quarter), up from between 25 to 28 percent in 2001.<sup>107</sup>

Cable telephony is poised to become even more widely available in the very near future. The cable operators that have not pursued circuit-switched cable telephony have done so in order to wait for voice-over-IP technology,<sup>108</sup> which they view as cheaper and more efficient than the circuit-switching approach used today.<sup>109</sup> Recently, however, a number of major cable operators

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<sup>102</sup> See Dan Somers, President and CEO, AT&T Broadband, *Operational Overview*, AT&T Broadband, Investor Presentation, July 2001, at 16 (stating that AT&T's network in Boston has "2.9 million homes passed," that "plant upgrades [are] nearly complete, [to be] able to offer complete bundle," and that there is already "11% telephony penetration" and ">100k customers.").

<sup>103</sup> As of mid-2000, AT&T offered cable telephony to at least 165,000 of its approximately 400,000 subscribers in the Pittsburgh Area. See *Company Offers Free Phone Service in Bid for Customers*, Associated Press State & Local Wire (Aug. 31, 2000); NCTA, *Top 25 Cable Systems*, [http://www.ncta.com/industry\\_overview/aboutIND.cfm?indOverviewID=56](http://www.ncta.com/industry_overview/aboutIND.cfm?indOverviewID=56). AT&T's network passes roughly 600,000 homes, assuming a nationwide cable penetration rate of approximately 66 percent.

<sup>104</sup> See Dan Somers, President and CEO, AT&T Broadband, *Operational Overview*, AT&T Broadband, Investor Presentation at 17 (July 2001) (stating that AT&T's network in Chicago has "3.5 million homes passed," a "strong telephony roll-out" with "backbone and headend segments of rebuilds nearly complete," "18% telephony penetration" and "some suburbs have 40% penetration.").

<sup>105</sup> See *id.* at 18 (stating that AT&T's network in the Bay Area has "2.7 million homes passed," "backbone and headend segments of rebuilds nearly complete," "19% telephony penetration" and "many communities in high 20s").

<sup>106</sup> See, e.g., Dan Somers, President and CEO, AT&T Broadband, *Operational Overview*, AT&T Broadband, Investor Presentation at 16-17 (July 2001) ("Some [Chicago] suburbs have 40 percent penetration."); Cox Communications, *Whitepaper: Preparing for the Promise of Voice-over Internet Protocol (VoIP)* at 1 (Feb. 2003), <http://www.cox.com/PressRoom/supportdocuments/VOIDwhitepaper.pdf> ("in areas where the service has been available the longest, penetration is . . . up to 40 percent."); J. Granelli, *Expanding Cable Telephony Is New Kid on SBC's Block*, L.A. Times (Jan. 21, 2003) ("As of the end of September, Cox provided telephone service for 30% of the 304,000 households it has wired in 14 south Orange County cities, where nearly all the homes are hooked up. It has a similar share in the San Diego County communities it serves."); AT&T News Release, *AT&T Broadband -Comcast Merger Will Create More Competitive Marketplace* (Apr. 23, 2002) (Then AT&T chairman C. Michael Armstrong said "AT&T Broadband has already gained 25 percent or higher cable telephony penetration in 55 communities").

<sup>107</sup> S. Rosenbush, *Broadband Telephony*, Business Week Online (Spring 2003).

<sup>108</sup> A. Breznick, *Top MSOs Wait Till Next Year for VoIP Launches*, Communications Daily (Mar. 13, 2003) ("It looks like it'll be at least another year before cable operators start offering voice- over-Internet Protocol (VoIP) service commercially to their subscribers . . . [C]able operators are wary of entering an unproved market with new technology and little operating experience. Many are waiting for the further maturation of new technical standards for the technology, as well as the development of solid business models for the service."); S. Buckley, *Triple Threat: MSOs Have Multiple Options for Next-Gen Voice*, Telecommunications Americas Edition (Feb. 2002) ("Charter Communications, Time Warner and Comcast took a wait-and-see approach for full VoIP solutions.").

<sup>109</sup> See C. Kuhl, *Cable Starts Dialing For Dollars With VoIP*, Communications Engineering and Design at 12 (May 1, 2002) (Steve Craddock, Comcast's senior vice president of new media development: "All the economics

have begun deploying the service commercially. And every other major cable operator is conducting trials of IP telephony and has announced plans to deploy the service commercially in the future.

- Time Warner Cable has recently introduced the company's first commercial application of IP telephony service throughout its Maine service area, which it refers to as its "Digital Phone" service.<sup>110</sup> The new service "is being sold as a primary line replacement," and includes "all the requirements for lifeline service including call signaling, dynamic quality over service, 911 support and CALEA support through adjunct servers."<sup>111</sup> The company plans to introduce the service in at least two other markets this year.<sup>112</sup>
- Cablevision announced recently that it also "has started to offer [IP telephony] to select customers in the New York suburbs."<sup>113</sup> Cablevision plans to conduct an expanded field trial of its "OptimumVoice" primary-line VoIP service in Long Island, N.Y. this summer, which is expected to lead to a broader commercial rollout by January 2004.<sup>114</sup> Cablevision recently signed a contract with Siemens AG for VoIP equipment and software. According to Siemens voice-over-cable solutions manager Mike Clement, "We're definitely providing [Cablevision] with large-scale deployment capability."<sup>115</sup> The basic system offered by Siemens can support more than 100,000 subscribers.<sup>116</sup>

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of circuit switched (approaches) have been exploited, but VoIP and softswitches haven't, and are still in the R&D stage, so the costs will get even better."); J. Baumgartner, *Chasing the Fortunes of VoIP*, Communications Engineering and Design at 38 (May 1, 2003) (Sam Chernak, Comcast's vice president of VoIP: "In our view, the heart of the compelling economics of VoIP is the integration of the plant, with the same RF channel and the same device in the home supporting both high-speed data and voice service."); S. Hofstetter, *Triple Time*, Telecommunications America at 12-13 (Nov. 2002) ("While the circuit-switched model is difficult for MSOs to justify, the economics for VoIP look much more attractive.").

<sup>110</sup> E. Murphy, *Cable Company Expands Phone Service*, Portland Press Herald (Apr. 8, 2003) <http://business.mainetoday.com/pulse/030408cablefone.shtml> ("The new service replaces Line Runner, which was Time Warner's test phone service and was intended as a second phone line, said Melinda Poore, the company's director of government and public affairs. Some initial bugs were worked out, and Digital Phone is intended to be used as a primary phone service.").

<sup>111</sup> See V. Vittore, *Time Warner Cable Launches VoIP Service*, TelephonyOnline.com (May 22, 2003).

<sup>112</sup> A. Breznick, *Big MSOs Gear Up for First Cable IP Telephony Rollouts*, Communications Daily (June 9, 2003) (quoting Time Warner senior vice president-voice Gerry Campbell).

<sup>113</sup> S. Rosenbush, *Broadband Telephony*, Business Week Online (Spring 2003).

<sup>114</sup> A. Breznick, *Big MSOs Gear Up for First Cable IP Telephony Rollouts*, Communications Daily (June 9, 2003).

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*



- Comcast began a field trial of primary-line VoIP service in Coatesville, Pa., approximately 40 miles northwest of Philadelphia. This trial encompasses five headends in an area where Comcast passes more than 180,000 homes.<sup>117</sup>
- Charter currently provides a primary-line digital phone service using voice-over-IP technology in parts of Wausau, Wis.<sup>118</sup> It also has recently completed a trial of primary-line voice-over-IP telephony in St. Louis.<sup>119</sup> Charter is currently “experimenting with different price points” in this system, and reports that it has quickly reached 10 percent penetration in its market area.<sup>120</sup>
- Cox recently initiated a six-month field trial of VoIP service in an undisclosed cable market after testing a hybrid IP-circuit switched service in Oklahoma City. Cox states that it is “prudently bullish on VoIP.”<sup>121</sup>
- Adelphia is conducting a trial of IP telephony in Buffalo in which VoIP equipment manufacturer “Arris has done voice over IP get ready work.”<sup>122</sup>

Cable operators are not the only companies pursuing IP telephony. Vonage – which bills itself as “the broadband phone company” – launched its DigitalVoice service using VoIP technology in New York in March 2002,<sup>123</sup> and expanded to the Boston region in May 2002.<sup>124</sup> The company introduced service to Philadelphia, Pittsburgh, the Delaware area, and southern New Jersey in September 2002,<sup>125</sup> and has since expanded service to markets that include Connecticut, the Washington, D.C. metro area, upstate New York, Rhode Island, New Hampshire, Harrisburg, Pa., and Norfolk, Va.<sup>126</sup> The company states that it provides “residents

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<sup>117</sup> *Id.* (quoting a Comcast spokeswoman).

<sup>118</sup> Charter Communications, *Wisconsin Telephone Features and Services*, [http://www.charter.com/pdf/wisconsin\\_telephone\\_services.pdf](http://www.charter.com/pdf/wisconsin_telephone_services.pdf); Charter Communications, *Telephone FAQs*, <http://www.charter.com/products/telephone/faqs.asp>.

<sup>119</sup> *North American Residential Cable Telephony Deployments and Trials*, CED (Apr. 1, 2003); Charter Communications, *Telephone FAQs*, <http://www.charter.com/products/telephone/faqs.asp>.

<sup>120</sup> V. Vittore, *Cable Players Tap Vendors for VOIP Service Rollouts*, *Telephony* at 12 (June 2, 2003).

<sup>121</sup> *See, e.g.,* A. Breznick, *Big MSOs Gear Up for First Cable IP Telephony Rollouts*, *Communications Daily* (June 9, 2003) (quoting a Cox spokesperson).

<sup>122</sup> *Q1 2003 Arris Group Inc. Earnings Conference Call - Final*, FD (Fair Disclosure) Wire, Transcript 042403ay.730 (Apr. 24, 2003).

<sup>123</sup> Vonage Press Release, *Vonage Announces the Next Generation of Broadband Phone Service with the Most Popular Features and Unlimited Calling for One Flat Rate of \$39.99* (Mar. 20, 2002).

<sup>124</sup> Vonage Press Release, *Vonage DigitalVoice Expands Service to the Boston Region* (May 21, 2002).

<sup>125</sup> Vonage Press Release, *Vonage DigitalVoice Launches Service in Philadelphia* (Sept. 17, 2002); Vonage Press Release, *Vonage DigitalVoice Launches New Phone Service in Pittsburgh* (Sept. 19, 2002); Vonage Press Release, *Vonage DigitalVoice Launches Delaware Area Code* (Sept. 20, 2002); Vonage Press Release, *Vonage DigitalVoice Launches New Phone Service in Southern New Jersey* (Sept. 23, 2002).

<sup>126</sup> Vonage Press Release, *Vonage DigitalVoice Launches Service in Connecticut* (Nov. 6, 2002); Vonage Press Release, *Vonage DigitalVoice Launches Service in the Washington, DC Metro Area* (Nov. 12, 2002); Vonage Press Release, *Vonage DigitalVoice Launches Service in the Rochester, Syracuse and Albany Areas* (Nov. 26, 2002); Vonage Press Release, *Vonage DigitalVoice Launches Service in Buffalo* (Dec. 4, 2002); Vonage Press

and small businesses a real alternative to Verizon by giving them free unlimited local and long distance phone service they install themselves, including all of the features, for an attractive price.”<sup>127</sup> In one year, Vonage has gained over 20,000 subscribers nationwide, and transmits 1.5 million calls per week over its VoIP network,<sup>128</sup> and as of May 2003, the company’s goal is to acquire 100,000 customers before the end of the year.<sup>129</sup> The company recently announced a partnership with Intrado to provide 911 emergency calling services to Vonage customers.<sup>130</sup> According to director of channel sales Michael Centrella, Vonage is also looking to partner with [cable] MSOs and large ISPs to “quickly sell [Vonage’s] voice services to these businesses without subjecting them to major expenditures or operational impacts.”<sup>131</sup> On June 9, 2003, Vonage announced that it partnered with Armstrong Cable “to deploy broadband telephony service to Armstrong’s cable television customers.”<sup>132</sup>

E-mail and instant messaging (IM) also now substitute for a large fraction of traffic switched on wireline networks.<sup>133</sup> A large and growing fraction of this traffic originates and/or terminates on competitive networks, but even when carried over ILEC networks, such traffic displaces significant usage-sensitive (e.g., per-minute or per-call) revenues that the ILEC otherwise would earn. There are now 900 million e-mail accounts in the U.S. and over 60 million IM users.<sup>134</sup> It is estimated that consumers in the U.S. are sending approximately 3.2 billion e-mail messages and approximately 1 billion IM messages *per day*.<sup>135</sup> If only 10 percent

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Release, *Vonage DigitalVoice Comes to Rhode Island* (Jan. 13, 2003); Vonage Press Release, *Vonage DigitalVoice Launches Service in New Hampshire* (Jan. 14, 2003); Vonage Press Release, *Vonage DigitalVoice Launches Service in Harrisburg, Pennsylvania* (Mar. 7, 2003); Vonage Press Release, *Vonage DigitalVoice Launches Service in Norfolk* (May 14, 2003).

<sup>127</sup> Vonage Press Release, *Vonage DigitalVoice Launches Service in the Washington, DC Metro Area* (Nov. 12, 2002).

<sup>128</sup> Vonage Press Release, *Vonage Becomes First Broadband Telephony Provider To Activate 30,000 Lines* (June 16, 2003).

<sup>129</sup> See Vonage Press Release, *Vonage Calls the Gardner-Nelson Project* (May 6, 2003).

<sup>130</sup> Vonage Press Release, *Intrado and Vonage Digital Voice Partner To Provide Emergency Calling Solution* (Mar. 25, 2003).

<sup>131</sup> Vonage Press Release, *Vonage Shifts Its Channel Sales Toward Retail, E-Tail, ISPs and MSOs* (Mar. 21, 2003).

<sup>132</sup> Vonage Press Release, *Vonage Digital Voice Announces Private Label Partnership with Armstrong* (June 9, 2003). Vonage announced a similar agreement with Advanced Cable Communications the next day. Vonage Press Release, *Vonage Digital Voice Announces Private Label Partnership with Advanced Cable Communications* (June 10, 2003).

<sup>133</sup> See, e.g., S. Flannery, *et al.*, Morgan Stanley, Investext Rpt. No. 7406622, Wireline Telecom Services – Trend Tracker: Bottom Line Better – Industry Report at \*29 (May 23, 2003) (“In the local market, access minutes of use (from long distance and CLEC carriers) decreased 8% [in first quarter 2003], versus [fourth quarter 2002’s] 9.8% decline. MOU growth has been weak in recent quarters for a number of reasons. First, we’ve seen a migration of traffic to dedicated access services, which are based on fixed charges rather than on switched access minutes of use. Second, and perhaps more importantly, we believe substitution of switched minutes to wireless, email, and other technologies is also having an impact, as wireless minutes are not typically included in the MOU count reported by the Bell companies.”).

<sup>134</sup> See D. Whelan, *The Instant Messaging Market*, American Demographics (Dec. 2001).

<sup>135</sup> See R. Gann, *Fast Talking Instant Messaging Software*, Internet Magazine at 140 (Jan. 1, 2001).

of the 4.2 billion daily e-mail and instant messages substitute for a voice call, that is equivalent to about 750 billion minutes per year, or roughly one-third of all voice traffic that passes through ILEC networks.<sup>136</sup> And while estimates vary, consumer surveys find that the actual rate of voice substitution is considerably higher.<sup>137</sup>

Facilities-based competition has also come from a number of carriers – including RCN, Knology, and WideOpenWest – that have deployed their own broadband pipe (generally either hybrid fiber coax or pure fiber) to provision high-speed bundled service offerings to individual neighborhoods or the approximately 30-35 percent of the population that live in multi-dwelling units.<sup>138</sup> These carriers now serve at least 353,000 subscribers and offer service to at least 1.7 million homes.<sup>139</sup> In Verizon's region, RCN has deployed networks in New York, Massachusetts, Pennsylvania, Maryland, and Washington, D.C. to compete with Verizon. Several CLEC affiliates of incumbent LECs – including PennTel and Hickory Tech – have also taken this approach.<sup>140</sup>

Finally, there continue to be a large number of carriers that operate competitive networks that they use primarily to serve business customers. According to ALTS, for example, “there are approximately 100 facilities-based CLECs in operation today,”<sup>141</sup> which operate nearly 10,000 switches (both circuit and packet),<sup>142</sup> and hundreds of thousands of route-miles of fiber.<sup>143</sup> Data

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<sup>136</sup> Ind. Anal. & Tech. Div., FCC, *Statistics of Communications Common Carriers* at Table 5.8 (2000/2001 ed. 2002) (Total 1999 Dial Equipment Minutes of 4.414 trillion divided by 2 yields 2.207 trillion conversation minutes; 750 billion/2.207 trillion = 33%).

<sup>137</sup> See, e.g., *Welcome to InstantMessagingPlanet.com*, InstantMessagingPlanet.com (Oct. 15, 2001) [http://www.instantmessagingplanet.com/features/article/0,,2841\\_903101,00.html](http://www.instantmessagingplanet.com/features/article/0,,2841_903101,00.html). (According to an InsightResearch survey “[f]orty-seven percent of consumers said they use instant messaging. And of those, 96 percent said they use IM at home and 20 percent use instant messaging at work. . . . Nearly half of all respondents, 49 percent, use instant messaging as a replacement for a telephone call while one third, 35 percent, use it in place of sending an e-mail.”); M. Dano, *IBM Enters Wireless Instant Messaging Arena*, RCR Wireless at 28 (June 25, 2001) (According to the Gartner Group, 60 percent of all real-time online communication – voice or text – will be driven through instant messaging technology.); T. Chea, *Workplace Is Being Altered By E-Mail*, Wash. Post at E07 (June 29, 2000) (In a study by Vault.com, 45 percent of respondents said e-mail has replaced phone calls.).

<sup>138</sup> See, e.g., Robert Currey, Vice Chairman, RCN Corporation, Prepared Testimony before the Senate Subcommittee on Antitrust, Business Rights, and Competition, Committee on the Judiciary, *Cable and Video: Competitive Choices*, Federal News Service (Apr. 4, 2001) (“About 30-35 percent of the population lives in multiple dwelling units (MDUs), such as apartments, cooperatives or condominiums.”).

<sup>139</sup> See Knology, Inc. Press Release, *Knology Reports Strong Operating Results in First Quarter of 2003* (May 13, 2003) (Knology, Inc. on-net telephone connections and marketable homes passed); RCN Corp. Press Release, *RCN Announces First Quarter 2003 Results* (May 14, 2003) (Total RCN connections: voice and Total RCN marketable homes); D. Hayes, *Are Overbuilders Keeping Pace?*, CED (Apr. 2002); A. Bryer, *Wide Open West Finds It's Tough to Beat the Incumbent*, Denver Bus. J. (Apr. 5, 2002).

<sup>140</sup> New Paradigm Resources Group, Inc., *Competitive IOC Report*, Ch. 4 at 2 (1st ed. 2001).

<sup>141</sup> *ALTS 2003 Report* at 7.

<sup>142</sup> *Id.* (CLECs operate 1,221 voice switches and 8,740 data switches).

<sup>143</sup> New Paradigm Resources Group, *CLEC Report 2003*, Ch. 4 at Table 12 & Ch. 5 (17th ed. 2003).

compiled by the FCC demonstrate that CLECs have captured approximately 23 percent of lines provided to “medium and large business, institutional, and government customers.”<sup>144</sup>

Although extensive facilities-based local competition has emerged, virtually all of the major independent analysts also now recognize the negative impact that the rapid rise of the UNE-P at TELRIC rates is having on that competition. For example, Legg Mason notes “the losses to UNE-P in recent quarters, including the migration from UNE-loops to UNE-platform,”<sup>145</sup> and observes that “UNE-P reduces [the] voice opportunity” for cable operators.<sup>146</sup> Salomon Smith Barney has recently stated that “the UNE platform remaining an option for competitive entry . . . is negative for all companies providing local telephony or planning to enter that business, including cable companies. Cox Communications, in particular, and Comcast (through AT&T Broadband) are most affected on a longer-term basis.”<sup>147</sup> Credit Suisse First Boston “turned pessimistic about the extent to which Cox . . . will generate money from offering local telephone service over its cable TV systems” due to “the long-distance carriers’ use of UNE-P [that] has picked up speed of late.”<sup>148</sup> Morgan Stanley commented that cable companies are “negatively affected by UNE-P.”<sup>149</sup> Facilities-based carrier Allegiance Telecom – which recently has declared bankruptcy – has likewise indicated that low UNE-P prices “mak[e] it more difficult for efficient facilities-based [competitive local exchange carriers] to compete.”<sup>150</sup>

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<sup>144</sup> 2002 *Local Competition Report* at Table 2.

<sup>145</sup> M.J. Balhoff, *et al.*, Legg Mason Wood Walker, Investext Rpt. No. 7301106, Shift in RBOC Valuations – Industry Report at \*15 (Apr. 1, 2003); *see also* R.E. Talbot, RBC Capital Markets, Investext Rpt. No. 7229059, Integrated Telecommunication Services – Moderating Expectations for Triennial Review – Industry Report at \*13 (Feb. 18, 2003) (“Competitor UNE Lines with CLEC switching declined to 35% (or 4.1 million) of total UNE switched lines. This compares to 39% (3.7 million) in the preceding six months and 67% as at December 1999. We expect this trend to continue as CLECs pursue UNE-P based strategies in additional markets.”).

<sup>146</sup> B. Levin, Legg Mason, *Washington Telecom & Media Insider* at 2 (Feb. 21, 2003); *see also* B. Levin, *et al.*, Legg Mason Wood Walker, *WorldCom/MCI Bundled Phone Offer Challenges Rivals, Regulators* at 4 (Apr. 23, 2002) (“Given how the [Neighborhood] plan affects the attractiveness of telephony to new facilities-based providers, the states may have to shift some of the costs . . . if they want to encourage new facilities-based competitors, such as cable.”); *see also* UNE Fact Report 2002, § V, attached to Comments and Contingent Petition for Forbearance of the Verizon Telephone Companies, *Review of the Section 251 Unbundling Obligation of Incumbent Local Exchange Carriers*, CC Docket No. 01-338 (FCC filed Apr. 5, 2002).

<sup>147</sup> N. Gupta, *et al.*, Salomon Smith Barney, Investext Rpt. No. 7238096, Cable – UNE-P Ruling Has Mixed Impact on Cable – Industry Report at \*1 (Feb. 21, 2003); *see also* J. Bazinet, *et al.*, JP Morgan, *The Regulatory Handbook: 2003; The Implications of Pending Regulatory Changes in the Telecom, Media, and Cable Sectors* at 13 (Jan. 16, 2003) (JP Morgan has stated that “[w]e believe the [cable] voice business could be positively affected if unbundled network element obligations are dropped. If they are, the ILECs will no longer be required to provide their voice network to new competitors entering the market. That would leave more of the market for cable companies, like Cox or Comcast.”).

<sup>148</sup> G. Mannes, *Cox Prospects for Growth May Be Fading*, The Street.com (Sept. 19, 2002), <http://www.thestreet.com/tech/georgemannes/10043045.html> (citing Credit Suisse First Boston analyst Lara Warner).

<sup>149</sup> S. Flannery, *et al.*, Morgan Stanley, Investext Rpt. No. 8821267, Wireline Telecom Services – The Local Report: A Break in the Clouds? at \*9 (Oct. 8, 2002).

<sup>150</sup> *See* Letter from Kevin M. Joseph, Vice President Government Affairs, Allegiance Telecom, Inc., to Magalie Salas, FCC, CC Docket No. 96-98, Attachment at 2 (Feb. 2, 2001).